Financial Leveraging In Community Development Rehabilitation

A Technical Assistance Guide

U.S. Department of Housing and
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Community Planning and Development

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Preface

This guidebook is one of three being issued by the Office of Urban Rehabilitation and Community Reinvestment of the U S. Department of Housing and Urban Development (HUD) to encourage partnerships between local governments and private lending institutions in financing housing rehabilitation

Two of these guides are designed to promote the use of Title I Property Improvement Loan Insurance as a tool in Community Development Block Grant (CDBG) rehabilitation. Title I insurance can be an important resource in facilitating the participation of lending institutions and in leveraging private funds with CDBG and other public funds.

The first document, *FHA Title I Property Improvement Loan Program: A Guide for Financial Institutions and Public Officials*, explains the operations of the Title I program and summarizes its key regulations. It also describes the way Title I insurance is being used with CDBG funds to make home improvement loans affordable for lower income property owners. More detailed information on the Title I program requirements is contained in the "Title I Property Improvement Loan Operating Handbook," HUD Document No. 4700.1.

FHA Title I Property Improvement Loans in Public Rehabilitation Programs: Case Studies is the second in the series. It offers a detailed study of the use of Title I by local governments, lenders, and State housing finance agencies in rehabilitation programs. This third guide, *Financial Leveraging in Community Development Rehabilitation*, provides a broader view of the use of public funds to generate commitments of private financing for housing rehabilitation.

Michael Ehrmann, Director of the Division of Rehabilitation Policy and Assistance, Office of Urban Rehabilitation and Community Reinvestment, has written these three documents. From 1971 to 1974, Mr. Ehrmann directed the Hoboken, New Jersey Municipal Home Improvement Project, where he developed the prototype program which combines public funds with Title I insured loans. As Deputy Director of the Housing Action Council in White Plains, New York, from 1974 to 1978, he organized a county preservation program incorporating a $12 million commitment in low interest Title I loans from 30 lending institutions.

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Chapter 1

Introduction

Nearly 2,000 localities throughout the country are using Community Development Block Grant (CDBG) funds to rehabilitate declining neighborhoods. Prior to the first availability of CDBG monies in 1975, most of the communities had limited experience in the field of housing rehabilitation. Consequently, local officials initially selected simple financing mechanisms to serve property owners in one or two target neighborhoods

In these initial programs, property improvements were generally financed through low-interest loans and grants made directly from CDBG funds. Private lending institutions were infrequently involved in publicly-sponsored financing strategies Over the past year or two, however, both public and private officials have shown increased interest in participating cooperatively in local rehabilitation efforts.

This guide has been prepared to assist local government officials interested in leveraging public dollars with private resources in the financing of home improvements. It includes a summary of basic approaches to leveraging, a review of the lending institutions which may become involved, and an analysis of commonly used lending tools. Finally, this guide offers specific suggestions on preparing for and negotiating leveraging agreements

What is Leveraging?

Leveraging combines public dollars with private dollars to create a pool of funds for rehabilitation loans at below-market interest rates. CDBG funds are used as a "lever" to involve private resources in public rehabilitation programs. With the inclusion of private funds, committed through negotiated "leveraging agreements," the scope and capabilities of local programs can be expanded dramatically

Amortized rehabilitation loans, which require regular repayment schedules, are the target of leveraging techniques. A "leverage loan" can provide desired interest rates to private lenders while public funds reduce the cost of the loan to borrowers.

Leveraging is being widely touted as a magical means to create a lot from a little. However, it may not do it all. It does not, for example, encompass direct grants or conditional loans that do not require regular repayment. Low-income homeowners who cannot afford to pay back any loan do not benefit from leveraging.

How is Leveraging Measured?

The benefits of leveraging schemes are generally expressed as a "leveraging ratio," e.g., "3-to-1, private-to-public dollars," This ratio describes the relationship between loan commitments made by the lender(s) and the CDBG funds needed to secure those commitments. The actual (or "effective") loan terms that are paid by borrowers are below the basic (or "market") rates that are returned to the lender. Given fixed amount of CDBG funds, larger commitments of private dollars result in more favorable leveraging ratios.

Describing a leveraging arrangement in quantitative terms alone, however, can be misleading since the ratio also varies with effective terms paid by the borrowers Generally, the lower the terms established by the public agency, the lower the lèveraging ratio. For example, an effective interest rate of 6 percent on rehabilitation loans may involve a "3-to-1" leveraging arrangement. Further subsidy to a 3 percent level requires expenditure of CDBG funds if the lender receives a comparable return, and the ratio may drop to "2-to-1."

The impact of public funds depends upon both the **basic terms** to be returned to the lender and the **effective terms** to be paid by the borrower. Since higher basic terms and lower effective terms require more public resources, both must be carefully considered by local officials who are planning leveraging negotiations.

Local agencies should also be aware of the importance of both **interest rate** and **term of repayment** when entering negotiations with private sector lenders. Together these factors constitute the loan terms. Since "time is money," lenders will generally negotiate for shorter terms of repayment. Since interest rates are the more visible features of loan terms, public officials tend to focus on lowering the rate. Both factors, of course, determine the monthly repayment obligation of the borrower.

There is no automatic "good" leveraging ratio, and no simple formula for determining the best local approach. Local officials must first ascertain their program goals and then apply the appropriate tools. Each community should design a preferred plan based on its program objectives

Who uses Leveraging and When?

In a growing number of cities, public officials need private sector financial involvement to stretch the impact of rehabilitation funds and to meet current and projected demands. When the level of applications for loans exceeds the supply of public resources, then local officials should explore techniques that use private funds. In turn, the demonstration of effective demand for loans is usually a key public argument in attracting the participation of private lenders. The recent passage of the Community Reinvestment Act, mandating increased investment by lenders in their own communities, is stimulating financial institutions to seek out new mortgage and loan opportunities.

What Benefits Does Leveraging Bring?

Leveraging can increase the lending capacity of local programs because private dollars become involved and because public funds can be disbursed at their "present value." Inflation will not reduce the impact of these funds as they are repaid over time, and more property owners can be assisted in the shortrun Further, proponents of leveraging cite financial returns that come to localities through stabilizing or increasing property tax revenues.

A well-negotiated leveraging agreement not only increases the supply of rehabilitation dollars; it can also relieve public agencies from certain time-consuming administrative functions. Lenders generally handle credit reviews and loan processing. This service saves public agency staff time and administrative expenses, while capitalizing on the lending expertise of professionals in the credit field. The government personnel can then concentrate on qualifying and providing direct financing for those residents whose incomes or credit histories preclude private loan approval, and on such other tasks as public information, development of work specifications, and rehabilitation monitoring.

As another direct result of leveraging agreements, lenders commit themselves to work together with the public agencies in the overall efforts to preserve low- and moderate-income neighborhoods. Such partnerships bring private capital for rehabilitation into areas of limited previous involvement and may also stimulate additional investments. With a growing stake in the housing preservation effort, lenders become more receptive to providing mortgage funds for purchase of target area properties and commercial loans.

The involvement of private institutions can also be an important psychological element in creating an "investment mentality" that attracts owners to the program. With both local government and private lenders committed to revitalization, owners are reassured about the stability of the neighborhood and are encouraged to reinvest in their properties.

Finally, leveraging can help local officials solve a CDBG funding dilemma. Whereas Congress and HUD have increased their emphasis on the use of CDBG funds to benefit low- and moderate-income residents, thereby requiring more restrictive eligibility standards in many local programs, effective neighborhood revitalization requires broad property owner participation. Middle-income owners frequently are unable or unwilling to contract for repairs when they must pay market rates on loans and mortgages. Leveraging arrangements can address policy conflicts between "benefits for low- and moderate-income" and "neighborhood-wide rehabilitation" by providing income-sensitive, sliding scale terms that use fewer CBDG dollars for higher income residents. Not every owner should receive public assistance, but income eligibility guidelines can be broader under leveraging than with financing techniques that rely entirely on CDBG funds.

In sum, leveraging offers a number of benefits to communities involved in property improvement activity. However, it is not the answer to all rehabilitation problems, and more traditional means of using CDBG funds will remain appropriate in some areas. For example, low-income owners may not be eligible for leveraged loans, and each community implementing leveraging will have to determine the appropriate program mix of leveraged and direct (100 percent publicly funded) loans and grants

What Are the Barriers to Leveraging?

Fewer than 10 percent of those localities using CDBG funds for rehabilitation prior to 1978 were leveraging private financial resources. While there is now evidence of increased activity between the public and private sectors over the past year, a majority of communities still use direct, 100 percent publicly-financed loans and grants. The strongest barrier to leveraging has been the local officials' lack of familiarity with basic concerns of private lending institutions. Conversely, lenders have been confused and cautious in their attitude toward government agencies.

Improved public-private sector communication can overcome these barriers. Public officials need information on private financial institutions, lending practices, and cooperative financing agreements. Lenders need to understand the objectives and processes of publicly-supported rehabilitation efforts. The information presented in this guide is designed to help public officials begin the communication process.

Chapter 2

Basic Approaches To Leveraging

Over the past few years, local agencies and lenders have experimented with methods of leveraging private dollars with public funds to produce below-market rehabilitation loans. Several basic approaches have emerged.

These leveraging techniques fall into two general categories: (1) the use of CDBG funds as a **direct subsidy** of individual loans to lower the effective interest rate or defray part of the repair cost; and (2) the use of CDBG funds as a **deposit** with a lender to increase private investments on terms consistent with the goals of public agencies. Public funds generally revolve and are "recaptured" under the second category.

Leveraging through Direct Subsidy

There are three related but distinct methods of leveraging with direct subsidies: (1) Principal Reduction Payments, (2) Interest Subsidies, and (3) Grants Rebates or Partial Grants.

(1) Principal Reduction Payments

Principal Reduction Payments apply the "lever" of CDBG funds to reduce the funds borrowed from a private sector lender. This payment serves to drop the effective interest rate paid by the applicant on the total cost of rehabilitation. The amount of the public payment is determined by the below-market interest rate established by the public agency.

The Principal Reduction Payment is calculated by computing the monthly cost of an individual loan at a below-market interest rate and then determining the principal that this monthly payment can support at available lender rates. The difference between this principal amount and the actual cost of the repair work is called the Principal Reduction Payment. It is made directly to a property owner after satisfactory completion of rehabilitation.

The following example illustrates this computation. A public agency wishes to provide financing at 6 percent interest for a 12-year term. It negotiates loan terms with a private lender at 12 percent for 12 years. The first step is to compute the monthly cost for the below-market loan, which is $97.59. At the 12 percent rate, a $97.59 monthly payment supports a $7,430 principal loan. The difference between this principal amount and the $10,000 cost of the rehabilitation work is $2,570, which becomes the Principal Reduction Payment. The leveraging ratio in this example is $10,000-to-$2,570, or nearly 4-to-1.

Principal Reduction Payments are approved only when a property owner also takes out private financing to cover the cost of work not to be covered by public funds. The public agency helps the property owner qualify for private financing by reducing the cost of the loan The relative proportion of private and public funds varies depending on the effective interest rate determined in the program guidelines and the actual rate received by the financial institution on its loan.

This technique is widely used in New Jersey, New York, and New England, and selectively elsewhere. It appeals to lenders who are interested in supporting local rehabilitation efforts but hesitant to assume supplemental administrative costs and responsibilities. Financial institutions use their own loan and mortgage credit reviews to process applications, and have generally been sympathetic on marginal cases. The fact that lenders are asked to fund less than total rehabilitation costs contributes to their cooperative attitude, loan officers regard the public payments as attractive additional equity in the structure.

For public agencies, the simplicity and economy of the Principal Reduction Payments system is its most attractive feature. The technique is simple because once the public payment is made, a local government need not have further financial involvement in the loan.* Furthermore, since the public subsidy computations are based on the present value of funds, the costs to the government are one-half of what they would if paid throughout the life of the loan.

* However, an increasing number of public agencies are including post-rehabilitation lien requirements in their contracts with homeowners, so that they can recapture part or all of the public payment if the property is sold within an established time period.

(2) Interest Subsidies

Interest Subsidies produce a similar effect to Principal Reduction Payments but through a different process. Under the Interest Subsidy approach, payments are made to the lender, rather than to the property owner, and the financial institution provides the total cost of rehabilitation at below-market rates. CDBG funds are used to pay the **difference** between the return to the lender and below-market repayments of the property owner.

The computation is somewhat more direct than in Principal Reduction Payments. As described in the previous $10,000 example, a market-rate loan (12 percent) requires a $131.34 monthly payment. If the public agency has set interest rates of 6 percent, the property owner is obligated for $97.59 a month. The difference between these monthly payments over a 12-year term is $33.75 – the monthly cost of CDBG funds. If these payments were made by the agency over the life of the loan, the total public payment would be $4,860.

In most Interest Subsidy programs, however, both the localities and the lender prefer a single payment at the time of closing to incremental monthly payments over the life of the loan. Such a payment is described as the "present value" of the $4,860 obligation. To compute the present value, it is necessary to determine the **principal** which can be borrowed for 12 years at 12 percent interest that carries a monthly obligation of $33.75. In this example, the amount is $2,570. This amount is always the same as would result under the Principal Reduction Payment, and the same leveraging ratio results.

A number of California leveraging programs, as well as some projects elsewhere, use the Interest Subsidy approach. It appeals to those lending institutions that want a fuller involvement in rehabilitation by writing the loan or mortgage notes for the total cost of each case. Also, the payment of the subsidy in a single sum to the lender at closing can be a significant incentive for participation. The institution has immediate use of these public funds for investments or other private lending purposes.

In the light of this advantage to the lender, public officials may negotiate some supplemental benefits for their program. One private sector concession might be a reduction in basic interest rates. Calculating a precise value of the advance funds to the lender would be complex, if possible at all, and it is substantially off-set by the "present value" formula Nevertheless, the issue of the lowering basic rates should be raised in negotiations.

A financial advantage of Interest Subsidies to public agencies is that lenders using this technique are remitting a portion of the subsidy upon early repayments of loans. This remittance reflects the fact that public agency payments are based on full-term costs. No comparable mechanism exists in the Principal Reduction Payment approach. Although it would be possible for the public agency using Principal Reduction Payments to place a lien on the property as a prepayment penalty, this process might inhibit property owner participation in the program.

(3) Grant Rebates or Partial Grants

Rebates are a third form of leveraged financing. This approach involves the payment of public funds to the property owner up to a fixed percentage of total rehabilitation costs. Depending on the owner's income, the rebate percentage may vary from 20 to 50 percent of total costs. The owner locates other means, not limited to bank loans, to finance the balance of costs.

In a 25-percent Rebate program, the property owner needs to finance only $7,500 of a $10,000 rehabilitation job. If these funds were borrowed at 12 percent interest for 12 years, the owner would pay $98.51 per month, as opposed to $131.34 if the loan were for the full $10,000. The leveraging ratio in this case would be $10,000-to-$2,500, or 4-to-1. The monthly obligation to the borrower is nearly the same as in the previous two examples.

Unlike the Principal Reduction and the Interest Subsidy approaches, rebates do not require formal arrangements between public agencies and private lenders. Public officials may establish relationships with financial institutions for referring applications but the responsibility rests with the owners to find the private financing. There is no requirement that the owner use the public payment to defer rehabilitation costs. The work could be financed entirely from private sources, permitting owners to make any use of the rebate that they choose. Rebates are attractive to property owners with their own savings.

Many low- and moderate-income homeowners who require loans or mortgages may discover that financing is difficult to obtain on their own, particularly for longer terms and low monthly payments. Most public agencies involved in Grant Rebates systems have not established formal relationships with local lenders, thus limiting the rehabilitation staff's ability to intervene on behalf of individual applicants. Since experience is showing the need for active public intervention, localities operating Rebate programs are encouraged to negotiate formal lender participation.

Leveraging through CDBG Deposits

Another category of CBDG financing mechanism leverages funds in a less direct manner. Here, CDBG monies are not used as direct payments to the borrower or lenders; rather, these funds are deposited with private lenders and provide security and other benefits on loans made at lower interest rates or other special terms. Lump-sum deposits can be used (1) as a direct exchange for certain special terms, (2) as an insurance guarantee, or (3) for "compensating balances."

(1) Direct Exchange

Some lenders request localities to make lump-sum deposits of CDBG funds in a special account as a condition for their participation in a leveraging agreement. These deposits are made at the time that the agreement is executed.

The use of such deposits is consistent with the CDBG legislation, and HUD has developed regulations that define circumstances under which they can be made. These regulations require lenders to provide special benefits (such as reduced interest rates, longer repayment terms, smaller downpayment, etc.) on loans and mortgages processed for program applicants. (See Appendix III for a copy of these proposed regulations.)

Each deposit agreement must describe the "special benefits" and must be reviewed and approved by the respective HUD Area Office. A factor in establishing lender commitments is whether or not public agencies earn interest on their deposits. If no interest is earned, then more extensive lender commitments are required.

As loans are paid off, the public monies on deposit may be returned to the locality or used to support further loan commitments. This approach is popular with those local agencies which are unsure about the flow of future CDBG grants from HUD and place a premium on their ability to recapture funds. However, they should consider the effect of inflation which can reduce the value of those funds by 50 percent over the repayment term of most rehabilitation loans.

(2) Insurance Guarantees

Other lenders have required CDBG-financed insurance on loans and mortgages as a condition for their participation in local rehabilitation efforts. Most lenders who make municipal insurance a condition of their participation want the funds to be placed in a separate account which the public agency cannot use for other purposes. If the insurance fund generates private loans for more than 100 percent of the public monies deposited, an indirect leveraging impact results.

Since HUD regulations on deposits apply when a reserve fund is established, lenders requiring guarantees must provide special benefits to program applicants. In Dallas, Texas, for example, the community development agency and 28 private lenders formed a consortium to help property owners in certain target areas. The financial institutions committed $4 million to a lending pool that provides home improvement loans at two or more points below conventional interest charges. This agreement has resulted from the city's deposit of $535,000 of CDBG funds in an insurance account to guarantee individual obligations.

Although the use of CDBG funds for loan insurance can produce a public benefit, it may duplicate the FHA Title I Property Improvement Loan Program. FHA Title I loans provide 90 percent insurance to lenders on each obligation, and insurance guarantees from CDBG funds are not likely to provide comparable coverage. Private institutions may show initial reluctance to use Title I because of misconceptions that it will involve them in inordinant paperwork and additional requirements. Experience is showing, however, that Title I is not a cumbersome process and that it can be an administratively convenient companion to leverage loan programs.*

* For more detail on the use of FHA Title I Insurance with CDBG rehabilitation, see the additional guidebooks produced by the Office of Urban Rehabilitation and Community Reinvestment, Washington, D.C. as described in the preface.

(3) Compensating Balances

A variation of the lump-sum deposit leveraging technique is known as "compensating balances," where CDBG funds are held by the lender in two separate accounts. The first, which is interest-bearing, guarantees a percentage of total losses from defaulted loans. A lender recovers such losses by drawing against this account. The second account, which is non-interest-bearing, can be used by the lender either to make loans (thereby reducing the cost of acquiring such funds from another source) or to invest in other purposes and retain the interest. In both instances, the public funds permit rehabilitation loans to be made at below-market rates.

Conclusion

Each of the leveraging approaches discussed can benefit both lenders and public agencies. Since local needs and lender objectives vary from community to community, there is no preferred leveraging method. Prior to considering which technique to pursue, local officials should analyze and understand the characteristics of their lending community, establish specific rehabilitation financing objectives, and determine which approach(es) to leveraging they should propose to financial institutions.

Chapter 3

Private Sector Lenders

Real estate transfers and property improvements involve a variety of private sector lending situations. These include commercial banks, savings banks, savings and loan associations, credit unions, mortgage banks, and life insurance companies. This chapter describes the major features of these institutions and their potential relevance to leveraging.

Commercial Banks

Commercial banks constitute the largest segment of the American lending community both in number of institutions and in total assets. In 1977, nearly 14,000 commercial lenders with 38,000 banking offices controlled $1,145 billion in funds or other assets.* Originally, demand deposits (checking accounts) were the primary source of commercial bank financing; but more than 60 percent of their current holdings are now derived from time deposits (savings accounts). State law regulates the number of branches each bank may operate. Where they are permitted to open branches throughout a city or State, commercial banks are expanding assertively.

Five thousand commercial banks have national charters, and 9,000 are chartered under State banking laws. All commercial banks belong to the Federal Deposit Insurance Corporation (FDIC) which provides insurance on deposits of up to $40,000. In addition, all national banks and almost 2,000 of the State banks are members of the Federal Reserve Bank System and must meet its minimum reserve requirements. When banks in the Federal Reserve System need cash for investment, they may borrow from one of the ten regional Federal Reserve Banks. Commerical lenders have greater financing flexibility than any other type of lending institution in times of tight credit.

Because of the broad services they provide, commercial banks are known as the "department stores" of the financial community. In real estate, they offer short-term construction financing, residential and commercial mortgages, and business and property improvement loans. They are a prime source of interim construction financing in large scale new development and rehabilitation projects. Of all lenders, commercial banks are also the most aggressive in marketing property improvement loans and other personal consumer loans. These institutions generally place property improvement and business loans at interest rates of 9 to 15 percent with 5 to 15 years terms.

Although residential mortgages constitute only 15 percent of all their lending activity, commercial banks are collectively the Nation's third largest holders of mortgage obligations. They frequently make residential mortgages to their checking and saving customers at interest rates equal to or lower than the charges on similar obligations placed by savings banks or by savings and loan associations. Commercial institutions can afford to provide their regular customers with attractive mortgage rates because of their high-yield business and construction loan portfolios.

Since commercial banks have centralized policymaking systems, they rely on executive management for policy direction. The bank president and one (or more) vice-presidents are the policymakers whose approval is necessary for leveraging arrangement with local governments. Public officials should negotiate with these individuals to obtain bank participation in the local programs; acquiring the support of branch (or unit) managers and mortgage/loan officers is also helpful.

Commercial banks involved in leveraging have varying procedures for individual loans. In smaller banks, branch officers generally make lending decisions; however, the larger institutions have centralized mortgage and loan departments. It is each bank's decision as to which system is used, and public officials should work within the institution's administrative procedure. Even when dealing with a centralized processing system, municipal officials should inform branch managers about the progress of local preservation efforts to ensure the bank's support for future projects.

Commercial banks have led the way in making commitments to a number of leveraging programs now underway. The commercial institutions have also generally been the first to make the reduced rate commitments in communities where lenders have voluntarily dropped their interest charges on rehabilitation program loans.

* This figure includes a number of institutions called "trust companies", which began as specialized lenders but now provide all commercial bank services.

Savings Banks

Although mutual savings banks are currently authorized by law in only 18 States, these institutions have been an important part of the lending community since early in the Nation's history Savings banks are particularly active in New England and the mid-Atlantic region. Of the Nation's 475 savings banks, three-quarters are located in Massachusetts, Connecticut, and New York.

Savings banks assets in 1978 were $150 billion, with more than 80 percent of the deposits concentrated in the three Northeastern States. Most savings banks insure their deposits through the FDIC. More than $112 billion of the assets of savings banks is invested in real estate. Sixty-five percent have been approved for mortgages on residential properties, primarily for use in 1-4 unit dwellings.

Savings banks have not traditionally been active in property improvement lending. Nevertheless, many have recently become aggressive in processing improvement loans and other consumer-oriented obligations. These banks may also make commercial mortgages for investor-owners of multifamily residential properties and business property owners. Interest rates on these latter obligations are often one to two percentage points lower than commercial bank business loans.

Since the bulk of savings banks' financing originates from deposits by local residents, agencies seeking leveraging agreements with these institutions can make compelling arguments to support the reinvestment of institutional monies in areas where the depositors reside. On the other hand, since these banks depend largely on time deposits for funds, the level of their available investment monies is quickly affected by changes in the economy.

The policymaking and credit processing procedures of savings institutions differ from those of commercial banks. Boards of trustees set overall policy and frequently review individual mortgage and loan applications. Board members are usually local citizens familiar with municipal problems and potentials. While this familiarity does not assure their support, the boards generally favor savings banks participation in leveraging. Public agency proposals should be directed to the chief executive officers of savings banks because they prepare basic policy recommendations to the boards.

When leveraging agreements are established with savings banks, branch loan officers prepare individual credit applications. Board review generally takes place on all prospective mortgages and often on property improvement loans as well. However, some large savings banks have recently expanded into multi-branch operations. Since a board role in the approval of individual loan and mortgage applications is impractical in these cases, the credit processing procedures for these lenders are similar to those of commercial institutions.

Savings banks are actively participating in a number of leveraging programs. They also have impressive records of favorable processing on individual applications forwarded by municipal rehabilitation staffs.

Savings and Loan Associations

Savings and loan associations have been formed by local business people to provide a revolving source of funds for building loans. These institutions are now the Nation's prime real estate lenders. Most of the 4,500 local S&L's throughout the country have just one or two offices; yet their total current assets are $460 billion. Collectively, savings and loans associations have the second highest growth rate of all types of financial institutions.

Savings and loans associations may be chartered under Federal or State law. A large number of the institutions have deposits insured by the Federal Savings and Loan Insurance Corporation. All 2,000 federally approved institutions, and many of the 2,500 State chartered associations, are members of the Federal Home Loan Bank System, which regulates member associations, requires minimum reserves, and enables institutions to borrow funds for additional cash flow. As a result, S&L's are somewhat less affected by recessionary periods than are savings banks.

In 1969, 80 percent of S&L assets were invested in mortgages, most of which being in 1-4 unit residential structures. Savings and loan associations usually do not seek commercial investments; and until recently, they were minimally involved in property improvement lending. However, S&L's have recently expanded their services so that they now are increasing their concentration on consumer services and property improvement loans. The executive officers of savings and loan associations influence institution policy and loan approvals more than their counterparts in savings banks where directors are likely to be general policymakers. Consistent with the specialized nature of their operations, S&L boards frequently are composed of technicians in real estate related fields. When local officials pursue S&L support for rehabilitation financing, they should approach association presidents for negotiation.

Savings and loan associations are involved in a number of CDBG leveraging programs and Neighborhood Housing Services (NHS) projects, co-sponsored by HUD and the Federal Home Loan Bank Board's Neighborhood Reinvestment Corporation. Additionally, the United States Savings League, which is the S&L's major national trade association, encourages active member involvement in neighborhood preservation lending.

Credit Unions

Credit unions are assuming an increasingly important role in all types of lending. Nationally, there are 22,500 credit unions, with total assets of $54 billion. Credit unions are the fastest growing type of lending institution; since 1970, they have doubled their assets. However, 70 percent of all credit unions still have individual assets under $1 million.

A credit union is a financial cooperative. Unions are frequently organized at a place of work, where savings deposits can be deducted from employees' payrolls. Depositors receive interest rates higher than those available from other financial sources. At the year's end, surplus funds are distributed to members in supplemental interest or in rebates on loans.

Credit unions now hold 17 percent of all consumer loans. Nearly 85 percent of credit union assets are invested in consumer lending, including property improvement loans, and they charge lower interest rates than either commercial banks or finance companies. For example, their average charges are 8-10 percent on property improvement loans, significantly lower than the 10-14 percent offered by other institutions.

Credit unions often use the FHA Title I Property Improvement Insurance program in property improvement lending. Initially, they concentrated on short-term commitments; but recently, they have increased terms to the 12-15 year repayment periods allowed under FHA regulations. They now process limited numbers of residential mortgages as well.

Public officials interested in working with credit unions should first identify those groups with members who are target area property owners. Since credit unions have specialized memberships, there will probably be a need to negotiate with more than one small institution. However, the low cost loans provided by the unions will make this extra effort worthwhile. Local agencies will be saving public subsidy funds, and participating credit unions will be helping their own members.

Mortgage Bankers

Mortgage bankers are intermediaries for government-insured real estate activities. As specialists in volume realty investments, mortgage bankers process mortgage applications, originate commitments, and provide long-term servicing of the obligations they place. Generally, they do not hold onto the mortgages but sell them to individuals, banks, lender consortiums, life insurance companies, and to such secondary market institutions as the Federal National Mortgage Association. Funds earned from resale and fees are reinvested by being placed into additional mortgages.

This intermediate function is not needed for small scale property improvement activity; however, officials will find it advantageous to involve these firms when they get into multiple-unit rehabilitation activities.

Life Insurance Companies

Life insurance companies currently have invested more than $72 million in real estate. Insurance companies do not normally process individual residential mortgages and property improvement loans; but they can provide support for multi-institutional lending consortiums organized to help finance rehabilitation. Initial commitments to structuring lending pools by insurance companies may stimulate other financial institutions to participate.

Private Lenders and Public Lending Agencies

A number of State housing agencies and other public organizations are engaged in direct lending for rehabilitation. Many of these institutions are working cooperatively with private lenders to provide rehabilitation financing. One example is the Minnesota Housing Finance Agency's joint venture with private lending institutions to make FHA Title I property improvement loans available to owners. In this effort, lenders originate loans and sell the notes to the public financing agency, which then provides loan subsidies for its lower income applicants This approach has been adopted in New Jersey and may soon be applied in Michigan, Virginia, Tennessee and California, where similar programs are being negotiated.*

* See *FHA Title I Property Improvement Loans in Public Rehabilitation Programs, Case Studies,* cited in the preface, for a detailed description of the Minnesota and New Jersey lending efforts

Chapter 4

Private Sector Lending Tools

Having looked at lending institutions, it is appropriate to examine the lending tools available from those institutions. Three main types of private sector financing are useful for public rehabilitation programs – property improvement loans, mortgages, and business loans. (Construction loans may occasionally be needed). These lending tools may be applied to rehabilitation as follows:

Residential Rehabilitation	*Business Rehabilitation*
all property improvement	Title I FHA insured property
first mortgages	commercial mortgages
second mortgages	business loans

All lending tools will vary with the specific program, State, and institution providing the financing. Following is a general description of the major lending tools; more detail is provided in Appendix II.

(1) Property Improvement Loans

Property improvement loans are a primary resource for rehabilitating small, individually-owned structures. Nearly $5 billion in property improvement loans is borrowed annually, and all types of lending institutions market these loans. The specific characteristics of individual loans vary with the lending institution and State law. A basic variation depends on whether the loan is conventional, i.e., uninsured or insured by private companies; or if the loan is federally insured by HUD/FHA through the Title I Property Improvement Loan Program.

Property improvement loans are usually processed by the installment loan divisions of private financial institutions. These loans have been available since the 1930's, but ony recently have they been combined with public funds to rehabilitate property in low- and moderate-income areas.

Most CDBG rehabilitation efforts emphasize the upgrading of 1-4 unit residential and small commercial structures for which rehabilitation costs range from $5,000 to $15,000. Property improvement loans are the most convenient tool for the leveraged financing of these projects. The lending ceilings are high enough to support rehabilitation costs; repayment terms meet many borrowers' ability to pay; processing time is short; and loan fees and paperwork are minimal. The market interest rates on these loans are high, but CDBG funds can reduce charges to affordable levels.

Normally, only repairs and modification of residential structures can be financed with conventional property improvement loans; they cannot be used to purchase or build properties and to refinance existing mortgages. The lending ceilings are generally $10,000. Even in States such as California and Texas where higher ceilings are allowed, most actual uninsured lending is far less than $10,000. Conventional loans are usually payable over 7-10 years at a rate of 10-14 percent. Processing takes no more than a week. Fees are low – from $15 to $20 for credit processing, and another $75 to $100 when a lien is placed on the property. Legal services are not required for improvement loans, so no legal fees are incurred.

HUD/FHA Title I insured loans vary somewhat from conventional obligations.* The same type of activities can be financed, except that new construction is allowed when it is supportive of existing facilities. Improvements to commercial or mixed-use buildings may also be financed, but must be limited to physical repairs and installation of attached fixtures. On commercial structures, for example, fixtures such as shelves, counters, ranges, sinks, and signs are not eligible.

Federally-insured loans have ceilings that are higher than conventional loans – $15,000 for a one-unit property and $25,000 for a multi-unit property (but no more than $5,000 per unit). Loans may be repaid over 15 years at an interest rate of 12 percent or less, including a ½ percent insurance premium paid by the lender. Processing time is the same as for conventional loans, except for loans of $15,000 or more which must be reviewed by HUD Area Offices. Federal regulations limit the supplemental charges that can be levied on the borrower. Lenders must pay recording fees or required liens; on Title I loans, lenders are not allowed to charge homeowners a separate credit processing fee.

* For more details on the Title I program, see the companion guidebook, *FHA Title I Property Improvement Loan Program: A Guide for Financial Institutions and Public Officials.*

Lenders determine eligibility for all property improvement loans based on the borrower's ability to repay the obligations. Lenders generally use their normal credit procedures in processing FHA Title I loans, with HUD review of loan packages on the applications for $15,000 to $25,000. Financial institutions have credit formulas which compare an owner's total indebtedness (including the proposed loan) and income to total housing costs, including payment of new obligations and income. Generally, the allowable indebtedness between the first and second items in each formula ranges from 30-50 percent of total costs.

Though there are exceptions, lenders are generally reluctant to process applications from borrowers who already have more than one obligation on their property However, if a property has a first mortgage, the loan will only affect the lending determination if it contributes to obligations which exceed an institution's credit formula.

Property appraisals are not a factor in home improvement lending A lender who requires an appraisal and an accompanying formal recording of a full mortgage security is actually offering a second mortgage rather than an improvement loan

Most improvement loans do not involve any liens or mortgages.* However, Title I regulations require use of liens on loans of $7,500 or more, and some institutions have similar policies on conventional lending. In such cases, most States allow institutions to place "short-form" liens on the affected premises. These documents are simple to prepare and require no formal appraisal or complete title search. They may be recorded based on a limited title examination back to the last transaction on the premises.

On most property improvement lending, loan proceeds are paid either before or after repairs. If public officials want to set up a progress payment system for rehabilitation work, they must temporarily use their own funds or require applicants to place loan monies received from lenders in a municipally supervised escrow account. Funds are released to the owners and contractors, as agreed, upon completions of portions of work. When this procedure is used, repayments begin 30 to 45 days after the borrowers receive initial checks and sign them over to the public agency.

* A lien is a claim that one person or institution has upon the property of another as a security for a debt. A mortgage is the most commonly used legal document for liens when real estate is pledged as security for a loan.

Improvement loans have certain limitations, such as repayment terms which are far shorter than the limits in Federal Section 312 loans and most mortgages. These may generate monthly payments which are not affordable for low-income applicants. Public agencies can respond to this problem by providing extra subsidies. For example, offering an effective 1-percent rate on 15-year lending generates a monthly payment which is comparable to Section 312's 3-percent loan for 20 years.

The necessity to provide a heavy subsidy may disturb those officials who are resistant to having CDBG funds subsidize what many consider excessive private sector loan rates. Voluntary reductions by lenders of market interest charges as part of a "mutual subsidy" leveraging arrangement discussed in more detail below, may increase the local agencies' interest in leveraging and willingness to offer deeper subsidies when needed.

If municipalities feel that longer term lending is necessary, notwithstanding any subsidy, or wish to help applicants refinance their current obligations, then they will have to negotiate mortgage commitments as part of their leveraging agreement with financial institutions

(2) Mortgages and Deeds of Trust

Mortgages and deeds of trust are key resources for real estate financing. Technically, mortgages are legal documents protecting lenders or individuals who invest in real estate. As security on an obligation, the property is pledged to a lending institution. In event of default, a lender may foreclose, assume ownership, and regain funds by selling the property. Such lending incorporates a mortgage agreement and a promissory note or bond which encompass ongoing principal and interest charges. In comparison, most property improvement loans require only promissory notes.

Mortgages are available on a conventional basis, i.e., insured through private companies or uninsured; or they are available with Federal insurance from HUD/FHA or the Veterans' Administration. Mortgages can be used in the purchase of new or existing structures, the rehabilitation of previously constructed properties, or the refinancing of current obligations. Thus they offer some opportunities which property improvement loans do not.

Conventional mortgages are available for small structures, multifamily residential properties, and commercial buildings There are usually no statutory limits on lending ceilings, which are generally established by appraisal guidelines Mortgage repayment terms range from 25-30 years, but sometimes are limited to 15-20 years on existing structures in urban areas. Nevertheless, the terms are longer than those available on property improvement loans.

Interest rates on conventional mortgages are between 9½-10 percent on residential structures, depending on whether State usury ceilings fix maximum rates. Commercial rates depend on an applicant's credit standing, type of institution, and local variations; the range is from 9½-15 percent. Normal processing time for conventional mortgages is about 2-4 weeks.

Although conventional mortgages require a downpayment of 20-30 percent of the total purchase and/or rehabilitation financing costs, the public subsidy payment can help meet this requirement. When mortgages are used for rehabilitation, the owner's cash equity in the property often covers the downpayment requirements anyway.

Paperwork and fees on conventional mortgages are substantially greater than for property improvement loans. Extensive supportive documentation must accompany mortgage applications, and fees run as high as $300 on a $20,000 mortgage. Borrowers must also place a year's funds for mortgage and tax payments in an escrow fund administered by the financial institution.

Mortgage approvals are based on credit determination regarding an owner's ability to pay and on formal property appraisals. Credit formulae are similar to those used for property improvement loans, the most frequent being the housing cost/income comparison Property appraisal standards depend on the specific State law and type of lending institution involved Financing for 70-80 percent of the appraised property value is usually allowable on uninsured first mortgages and refinanced mortgages. With Federal or private mortgage insurance, this figure may go up to 90-95 percent.

A property appraisal ascertains the current and future value of a structure It reflects a building's physical conditions, neighborhood quality, and local tax assessment values. Mortgage appraisal requirements may pose problems for financing which are usually the targets of CDBG rehabilitation. Most lender appraisers are oriented toward working with new or existing structures in stable or improving neighborhoods. When they appraise buildings in transitional or deteriorating areas, they often make very conservative judgments on property values. Frequently, appraisals reflect little more than judgment of current worth even if rehabilitation is proposed Thus, the established values may preclude the level of improvements necessary on structures being considered for financing.

Fortunately, some lenders have begun altering their appraisal standards to be more supportive of rehabilitation activity. For example, a pilot effort in Baltimore uses a neighborhood-oriented appraisal system to stimulate investments in urban areas. Public officials using private mortgages as a leveraging tool should determine the compatibility of appraisal approaches with preservation goals.

FHA-insured mortgages have some different features from conventional lending. They are available for residential properties only. In the 203(b) single-family (1-4 units) program, the following lending limits apply· $60,000 for a one-family unit, $65,000 for 2-3 unit residence, and $75,000 for a four-family residence.* Maximum repayment terms are generally 30 years, although 35 years is permitted at 9½ percent, the statutory maximum. They may be adjusted below this ceiling by the Secretary of HUD.

Paperwork on insured mortgages is somewhat more extensive than for conventional borrowing and the processing time is longer. However, downpayments are smaller – 10 percent or less of the total financing cost. Fees may be up to 2 percent of the total mortgage value, in addition, some lenders require that borrowers pay a ½ percent insurance fee based on the declining mortgage balance throughout the life of the loan. In Title I property improvement loan programs, the lender pays this fee.

Federally-insured mortgages provide for payment of the entire mortgage proceeds at closing. In rehabilitation financing, this means that an owner does not receive funds until all improvement work is complete. In such cases, interim construction financing may be needed for progress payments during rehabilitation.

* There are a number of HUD/FHA mortgage insurance programs and their requirements vary. Handbooks and other information on individual programs can be provided through HUD Area Offices.

Although few lenders make first mortgages available when funds to be borrowed are less than $10,000, at least one creative program has been able to get financial institutions to offer mortgages on smaller amounts. In Amsterdam, New York, the rehabilitation target areas have large numbers of older structures with no existing indebtedness. Financial institutions asked to participate in a leveraging arrangement had little experience in unsecured property improvement lending and did not believe that FHA Title I insurance coverage would give them sufficient protection. Instead, lenders decided to offer secured first mortgages to program applicants, even when loans amounts were as little as $5,000. Although $100 to $200 in closing fees are required, interest charges have been at the New York State usury rate of 9½ percent rather than higher property improvement levels. The CDBG program covers closing fee charges, but still pays less than if it had to subsidize improvement loans at market rates.

Second mortgages are another lending tool with significance for local residential rehabilitation programs. They are a hybrid conventional financing resource that combines features of both mortgage lending and property improvement loans. Property appraisals and formal mortgage closings are required on second mortgages, and the total value of first and second obligations cannot exceed the relevant percentage of appraisal limit. However, processing time, required paperwork, and fees for these obligations are usually less than for first mortgages. Second mortgages generally have a lending ceiling of $10,000-$20,000, with interest rates of 9-14 percent. (Some States, such as New York, prohibit savings institutions from making second mortgage loans.)

While most public officials prefer working with improvement loans, which involve neither appraisals nor closings and have lower fees, lenders' willingness to make second mortgages available for leveraging with CDBG funds should not be ignored. In some areas, the financial institutions will require full mortgage security to be placed on every loan. Since first mortgage refinancing may not be practical, second mortgages offer these lenders and public officials an alternative. For example, many leveraging agreements in New England are incorporating the use of second mortgages. The participating lenders offer municipalities interest rates of 9-10 percent, charge fees of less than $200, and provide 10-year repayment periods in return for the security provided through mortgage liens.

The basic characteristics of all types of mortgage lending are summarized and compared in Appendix III.

(3) Financing Commercial Rehabilitation: Business Loans

Commercial rehabilitation projects can make use of commercial mortgages, offered primarily by savings institutions; Title I property improvement lending, handled by all institutions; and business loans, made exclusively by commercial banks. These business loans are available for replacement of equipment or additions to inventory. They may have lending ceilings in excess of $100,000, repayment terms of 5-10 years (unless the Small Business Administration insures the obligation for terms up to 25-30 years), and variable interest rates based upon the strength of an applicant's credit. Interest charges range from 9-13 percent.

In comparison to commercial mortgages and Title I property improvement loans, business loans are attractive because of their unlimited lending ceilings, the willingness of financial institutions to place loans as second obligations and the applicant's ability to use part or all of the proceeds for fixtures and inventory. (This advantage does not affect most CDBG commercial rehabilitation efforts, however, which rarely subsidize fixtures or inventory purchases.) Negatively, business loans have shorter repayment terms and higher interest rates than other loans and mortgages appropriate for commercial use.

Local commercial rehabilitation projects should have access to all three types of lending. Rehabilitation staffs encounter a mixture of applicant needs, reflecting a broad range of incomes and existing obligations on the properties. A wide availability of financing gives the local program the flexibility which is needed to respond to these applications.

(4) Construction Loans

CDBG financed rehabilitation does not usually require separate short-term construction lending to cover rehabilitation costs until work is completed and a permanent obligation is placed. Generally, the small size of the CDBG projects eliminates the need for advanced payment, or lenders are agreeable to progress payments on the proceeds of the permanent mortgage or loan. Otherwise, CDBG funds may be used for interim reimbursement of construction costs.

If construction financing is needed, funding is readily available. Commercial banks are normal sources for interim construction funds. Interest charges usually range above 9 percent. Local CDBG agencies may negotiate below-market rates on interim financing in return for commitment to supervise work progress. CDBG funds may also be used to subsidize construction financing interest rates, thereby generating a leveraging impact on the program monies.

Chapter 5

Preparing for Leveraging

Municipal officials must prepare carefully before presenting a leveraging proposal to private lending institutions. Two phases of analysis will be necessary: (1) projected financing demands must be established based on existing program efforts and projection of future need; and (2) levels, types and terms of financial commitments to be requested must be determined. Substantial groundwork in these two areas will facilitate the process of negotiations between public and private officials.

Projecting Financing Demands

Under the Housing and Community Development Act of 1977 and its regulations, local agencies can undertake two types of property rehabilitation activity: in Neighborhood Strategy Areas (NSA's), where there is a concentration of low- and moderate-income residents; and on a spot basis, with eligibility limited to low- and moderate-income property owners. The regulations require each CDBG applicant to prepare a detailed statement of short- and long-term preservation strategies. Such strategies must be based on a comprehensive demographic analysis and include specific rehabilitation plans for each target area.

To meet these program regulations and to establish annual funding allocations, officials should begin by preparing a three to five year financing plan. This plan should consider existing housing conditions, income characteristics of residents, and approximate costs of needed repair work. One methodology for determining overall financing needs is described in Appendix III.

The overall financing needs serve as a basis for allocating CDBG funds for rehabilitation loans and grants, and subsequently for loans to be leveraged with private resources. These budget decisions involve matters of public policy and cannot be made through objective analysis alone. The following process is being followed by a number of municipal officials:

- Establish income eligibility criteria for direct CDBG grants and deferred-payment loans – financing that does not obligate the owner for repayment.
- Determine the number of owners who are eligible for direct grants and deferred-payment loans and estimate the number who are expected to be served annually over the next three to five years.
- Multiply the average repair cost by the annualized number of owners eligible for direct CDBG financing and subtract this number from the projected volume of rehabilitation loans and grants. This figure will indicate the anticipated amortized loan volume.
- To determine the projected leveraged loan volume, reduce the amortized loan figure to reflect the number of owners who are not expected to meet private sector lending standards. Several communities have projected that 10 to 15 percent of their total volume will have to be supported through "direct" loans, 100-percent publicly funded.

This sequence may be reversed and still produce useful figures. For example, the number of owners who are eligible for amortized loans may be estimated and financing costs determined. The estimated community development funds required for the leveraged loan can then be substracted from the CDBG budget, leaving the remaining funds for direct financing. Regardless of the approach used to determine financing needs, public officials should be prepared to answer the question: How many leveraged loans do you expect to make through the program, and how much money is budgeted to subsidize their costs?

Lending Terms

The lending terms on the leveraged loans will influence the amount of public funds to be budgeted. The lower the interest rates and the longer the repayment periods, the greater the number of property owners who will qualify. At the same time, however, the greater the benefit provided, the more costly the program in public funds. Variable lending terms and associated public costs are illustrated through a series of computations in Appendix III.

As public agencies prepare to involve private lenders in their rehabilitation efforts, they must decide upon a balance between the benefits proposed and the leveraging impact desired. For the long-term success of rehabilitation efforts, however, the level of benefits (as described by the lending terms) is a more important consideration than the relative leveraging impact. Officials should establish lending terms which can stimulate maximum possible participation by eligible property owners. Decisions on the effective interest rate, the term of repayment, and the lending ceiling will determine the program's ultimate success.

Rates

ıunities have adopted a uniform interest percent for their leveraged loans. The f this approach is not surprising. Most e been reluctant to operate a multi-rate, ɜ program, fearing administrative ns. Furthermore, the 3 percent rate has the years to be an effective incentive for ıabilitation under the Section 312 program.

initial tendency toward fixed interest rates, is showing that the flexibility of multi-rate an provide a useful tool which does not ssive administrative burdens. For erest rates of 0-2 percent may qualify 's who cannot afford a 3 percent rate but eed a direct grant. These owners will s to additional financing, and the npact will be increased.* Similarly, 5 or 6 s for moderate-income owners may be attract their participation without an y expenditure of limited public funds. r interest "tiers" will provide financing to a ctrum of income levels, increasing pact and reducing political problems vith a narrow band of beneficiaries.

agencies have adopted slightly higher s for commercial and absentee-owned s compared with owner-occupants. e the position that owners of income- roperties deserve program support, but me levels as others. These below-market quently provided in return for certain (such as limiting rent increases) made by

e Interest rates do involve more ve screening than fixed rates. Public finding, however, that reviews of ncome tax statements, credit bureau verification of savings and checking ll establish the appropriate loan category se tasks can be completed in a week or

programs, loan limits are higher than the grant , many officials believe that owners who have to ament funds (even at zero percent interest) will abilitation efforts more seriously and ıan if monies are available as grants.

(2) Repayment Terms

Although interest rates have both real and symbolic importance for potential applicants, repayments terms actually have a more significant impact on the monthly obligation and affordability of loans. Public officials should give the repayment term issue attention equal to interest rates.

As noted, conventional property improvement loans have maximum terms of 7-15 years depending on varying State laws and whether Title I insurance is used. Public officials negotiating leveraging agreements that incorporate improvement loans should seek 10-15 year commitments from lenders, even though subsidizing loan terms requires increased public costs. Many applicants will not qualify for loans unless they have a minimum of 10 years for repayment.

If financial institutions make mortgages available for use in rehabilitation, they are likely to offer 15 to 25 year repayment terms. Local officials should consider subsidizing up to 20 year terms, but may choose to limit benefits to no more than this period. This position balances two considerations: the longer subsidized repayment terms reduces monthly payments, but the 20-year term places a limit on the CDBG funds expended on an individual property.

An alternative approach is to use Section 312 loans on all rehabilitation projects where the owner requires a 20-year term to meet monthly payments or to minimize rent increases.

(3) Loan Ceilings

As part of the preparation of their rehabilitation financing plans, municipal officials should compute the average cost per application expected in the local program. To develop maximum loan limits, public agencies must determine how much more than this average figure they are willing to finance on individual loans requiring larger sums. Generally, most CDBG program loan guidelines allow $5,000 to $15,000 for one-unit structures, $10,000 to $20,000 for two-unit dwellings, and $12,000 to $25,000 for three or more apartment properties. On commercial structures, the maximum limits range between $10,000 and $20,000.

Many local programs are now beginning to provide financing for the improvement of larger, multi-unit structures. These communities need to determine the upper cost limits for use of CDBG loans. As a general rule, CDBG financing is not the suitable approach for improvements costing more than $10,000 per dwelling unit, particularly if the public agency is unwilling to offer interest rates below five to six percent to owners of rental properties. Without a higher subsidy, the resultant rent increases would make continued occupany by low-and moderate-income tenants impossible.

On larger properties, the Section 312 loan program and the Section 8 Substantial Rehabilitation housing assistance program are more suitable financing sources. Section 312 loans now have a ceiling $27,000 per dwelling unit, and 20-year lending terms. This is substantially more than most local agencies will be willing to support with CDBG funds even on a leveraged basis. Section 8 provides subsidies to keep post-rehabilitation rents affordable for the low- and moderate-income residents of the affected structures.

Even where public agencies utilize CDBG funds for larger scale rehabilitation projects, and leveraging limits the public costs, most communities have remained unwilling to finance more than $40,000 to $60,000 to rehabilitate a particular structure. However, some larger cities, including New York and Chicago, now employ higher cost ceilings in their multiple dwelling loan programs. In Chicago, a CDBG rebate program provides 50 percent of rehabilitation costs on multifamily improvement projects for up to $250,000.

Determining What to Ask the Lenders

Once municipal officials have established their projected financing demands; including the value to be covered by leverage loans, they must clearly outline what requests they will make of private lenders. Before negotiations can actually begin, officials must be able to answer the following questions.

• *What Level of Private Sector Financing Will Be Needed?*

The level of private financing will be affected by:

1) The rehabilitation financing needs which can be met with private sector loan funds; and

2) The proposed program guidelines on interest rates and repayment terms which establish the level of public subsidy required on leveraged loans.

If projected rehabilitation activity will be in the property improvement lending range, i.e., under $15,000, then the public agency should assume a 12-year estimated average repayment term in determining the levels of public and private financing. If a number of larger projects are anticipated and the program is prepared to subsidize 20 to 25 year mortgages, an average term of 15 to 17 years should be used in computing the project's impact.

For the purposes of projecting anticipated leveraging volumes in proposals to lenders, public officials should assume that loans and mortgages will be available at market interest rates, i.e., 12 percent and 9½ to 10 percent, respectively. If a mix of loans and mortgages is anticipated, the number of applicants in each category should be estimated and an average rate derived.

Programs which plan to use a fixed loan rate can compute the monthly payment for a typical property to ascertain the level of required public subsidy. For a multi-rate program, the number of applicants at each level must be estimated, and these figures must be averaged to determine a median interest charge and monthly payment which compares with the lender costs.

Funding requests should reflect the total loan financing needs minus the proposed public payments. For example, if CDBG monies are leveraged 4 to 1, 75 cents of every dollar loaned will be financed through a bank loan or mortgage. If a program's overall rehabilitation loan requirements were for $500,000, then $350,000 would be requested from private sector lenders. After computing the amount of required private financing, public officials should add 10 to 20 percent to this figure to cover unanticipated program demands or increases in the project's level of leveraging.

• *How Specific Should Requests for Private Sector Funding Commitments Be?*

Due to the lack of precedent, early leveraging efforts did not generally include specific commitments of funds from lenders. Government agencies forwarded loan applications for approval to institutions on a case-by-case basis. However, more recent leveraging programs have included specific reservations by participating lending institutions. Gaining commitments is advantageous because the lenders tend to consider themselves as partners in the program's success and are thus more likely to review individual loan applications in a positive vein. Furthermore, the willingness of lenders to commit funds for revitalizing target areas may persuade reluctant owners to reinvest in their properties.

One drawback to private fund reservations is that these commitments may include dollar and time restrictions. However, these limitations are likely to be waived as the leveraging efforts succeed and all initial private sector fund reservations are used up. In virtually all such cases, lenders have been eager to provide additional monies. At the same time, rehabilitation programs with slow start-up report no difficulties convincing the financial institutions to extend or eliminate original time limitations. Whatever the level of program performance, some lenders will attach restrictions so that they may periodically review partnership arrangements or lending terms. In proposals to lenders, public agencies should indicate their overall needs and suggested institutional commitments, but leave the determination to commitment levels to the institutions that decide to participate.

• *What Private Sector Lending Instruments Should Be Utilized?*

Although lenders will ultimately determine the types of loans and mortgages to be used in their CDBG rehabilitation efforts, public officials should offer guidance based on the following considerations:

1) On repair projects of $15,000 or less, property improvement loans are an effective financing tool. They require limited paperwork, are quick to process, and do not involve property appraisals or extensive closing fees.

2) Although uninsured property improvement lending is normally a safe investment, the use of FHA Title I insurance should be considered. The easy availability of Title I coverage can encourage lenders to approve credit in unfamiliar neighborhoods. Further, Title I's 15-year maximum repayment term is longer than the highest period allowed on uninsured lending in most States.

3) High market interest rates, requiring large amounts of CDBG funds to bring the effective interest charges down to affordable levels, are a disadvantage of property improvement lending. When local target areas have many properties without existing mortgage indebtedness, and lenders can be convinced to provide first mortgages on loans of $5,000 or more, then mortgage lending may provide an attractive alternative to improvement loans. Mortgages have $100 to $300 closing fees, which local agencies may choose to pay; but their interest rates are 2 to 3 percent below those of improvement loans.

4) Before the jump in their interest rates several years ago, mortgages were often used to refinance existing property indebtedness and to cover new improvement costs. Today, however, any benefits of refinancing (even with a local subsidy of the rehabilitation costs) may be neutralized by the need to incorporate the older mortgages (at 4 to 7 percent) into a new 9 to 10 percent mortgage. Local agencies can subsidize both parts of a refinanced mortgage, but most officials are unwilling to use CDBG funds to subsidize previously incurred debts.

5) The Title I program allows up to $25,000 on repair projects for multi-unit dwellings, with 15-year repayment terms. If more than $15,000 is required for 2 to 3 unit structures, or if more than $25,000 is needed on larger properties and the 15-year Title I repayment term generates overly high mortgage repayments, then longer-term mortgage financing will be necessary.

6) When commercial rehabilitation programs allow improvements costing more than $15,000, business loans and commercial mortgages have to provide financing. Title I loans are good sources for commercial rehabilitation costing less than $15,000.

- *What Lending Terms Should Be Sought?*

A number of Northeastern financial institutions have joined local agencies in a "mutual subsidy" system. Interest rates on property improvement loans or second mortgages have been reduced from 11 to 14 percent to 8 to 10 percent; public subsidies are used to lower the effective rates to program levels. As a result of the private sector interest reductions, CDBG rehabilitation funds serve 25 percent more owners than would be possible at market rates.

Public agencies can make a good case for lender participation in such mutual subsidy systems. The approach leads to greater neighborhood upgrading and a concentrated reinvestment process which safeguards financial institution loans and mortgages. Since financial institutions have had limited loan and mortgage activity in most target areas, even lowered interest rates will return some profit to the lenders. At worst, they will break even on the new investments. Local agencies interested in gaining lender rate cuts should prepare computations showing the impact of reductions in lender interest rates. These figures show that lower private sector charges require limited public subsidies, allowing more property owners to be served with the available CDBG funds. Since many lenders are interested in a concentrated program impact, these computations can help convince financial institutions to provide rate reductions.

Where in effect, lender interest reductions on property improvement loans or second mortgages have usually brought the rates in line with first mortgage interest changes. Lenders recognize that the special services provided by the local agencies result in loans which have many of the characteristics and safeguards of mortgage lending. For example, public agencies process loan applications before forwarding them to participating lenders, thus saving the private sector substantial administrative costs.

One issue which lenders may raise during any discussion on rate reductions is "discriminatory ding". Private officials may fear that their ement to reduce interest charges on loans to icants referred by public agencies will cause rs to feel discriminated against. However, criminatory lending has not become an issue in any the existing mutual subsidy efforts to date. Citizens n these communities recognize the lenders' lower rates as part of a public program. Public officials can assuage concerns by offering to handle criticism that may arise.

Lender reductions on interest rates are worth exploring during the negotiations process. However, private sector commitments are the major goals of leveraging discussions and the rate issue should not be allowed to overshadow this goal. Even if the financial institutions receive market interest rates, public purposes are being served.

- *What Credit Standards and Processing Procedures Should be Suggested?*

As a condition of participating in leveraging agreements, private sector lenders are likely to insist on processing their own loans and retaining their customary credit standards. However, experience indicates that once financial institutions become partners in leveraging, they review program loan applications with a strong disposition to approve financing requests. Sympathetic credit processing, combined with public subsidies to reduce the owner's costs of borrowing, qualifies large numbers of additional applicants.

Sometimes eligible property owners with large debts or previous credit problems will not qualify under private standards – or even for the direct CDBG loans set up to service applicants turned down by lenders due to insufficient income. The CDBG experience to date shows that neither public officials nor participating lenders need to fear political pressure or community criticism if they fail to serve every interested owner. The public does not expect solutions for every problem, so long as overall program performance is creditable and loan rejections are explained.

There are also steps which can be taken to minimize loan rejections and to eliminate misunderstandings. Financial institutions can provide advance knowledge of their credit standards, enabling local officials to explain the criteria to potential borrowers, refer applications to lenders with the most appropriate standards, and predetermine that certain owners will require direct grants or loans.

Supportive lenders should inform local agencies and applicants of the specific reasons for loan rejections. This procedure will reduce misunderstandings. Furthermore, some applicants who have been rejected have found inaccuracies in their credit records. Adjustments have been subsequently made, and they have successfully reapplied for the loan.

Several leveraging programs refer cases to more than one financial institution. Since credit standards vary, this "shopping" technique frequently yields positive results. Private lenders usually request that there be a limit on the number of attempts made and that each lender be informed of the reasons for rejections by other institutions. This procedure rarely is used, however, where previous credit difficulties appear on the records. Some officials successfully respond to loan rejections based on inadequate borrower income by resubmitting the applications for a reduced loan value.

- *Which Financing Mechanism is Most Suitable?*

Public officials need to determine which of the leveraging approaches is most appropriate for their local program and recommend this mechanism to private sector lenders. However, they should also remain flexible. If private institutions propose alternative mechanisms or ask the government to develop an approach, not originally proposed, public officials should be prepared to consider modifications in their original plans.

Chapter 6

Negotiating Leveraging Agreements

To obtain private sector commitments to CDBG rehabilitation programs, public officials must enter detailed negotiations with financial institution representatives Communities entering negotiations may utilize strategies that have been effective elsewhere. This chapter will assist public agencies to prepare a written proposal for lender participation, to plan meetings with private sector officials, and to negotiate leveraging agreements

The Written Proposal

Sometimes public officials prefer not to distribute written proposals until informal meetings have been held with private sector representatives. However, they should prepare a draft version of this information before any actual negotiation Formulating this document helps to refine key issues and prepare more effective presentations. A written proposal, limited to 4-8 pages, might contain the following elements:

1. *Cover Letter:*

A covering letter from the local chief executive requesting lender support

2 *Problem Statement·*

A summary of the need for rehabilitation.

3. *Basic Objectives:*

Summary of three or four major objectives to be met by the program.

4 *Description of Target Area(s) and Properties to Be Covered by Spot Rehabilitation:*

• Boundaries of neighborhood(s)
• Number or size (units) of structures in each area and in the spot program
• Analysis of ownership types, i.e., owner-occupants or absentee owners.
• Summary of income data on both owners and tenants.
• Summary of code violations in the target area(s); if unavailable, a summary description of property conditions in the neighborhoods.
• Descriptions of community organizations and major neighborhood activities in the target areas.

5. *Rehabilitation Program Description:*

• Basic services to be provided.
• Eligibility standards for loans.
• Program goals: number/type of owners to be served subject to successful negotiation of leveraging.
• Proposed lending terms, with indication that these are subject to completion of discussions with lenders:
  –loan ceilings
  –interest rates
  –repayment terms
• Rehabilitation standards and procedures for rehabilitation monitoring.
• Cost standards and procedures for selection of contractors.
• Other program rules: rents and evictions, tax assessment policies, etc
• Plans for outreach and citizen involvement.

6 *Proposed Municipal Role:*

• Program Staffing.
• Funds reserved for rehabilitation loans and grants.
• Projected public improvements and services in target areas, including dollar value.

7. *Commitments Sought From Lenders:*

(This Section may be placed at the beginning of the presentation).

- Basic reasons for seeking a leveraging arrangement.
- Description of mechanism proposed to be used in combining public and private funding.
- Overall fund commitments sought from lenders. (This figure should be justified in relation to data on program goals, expected average rehabilitation costs per structure, and proposed public expenditure for rehabilitation loans and grants.)
- Range of funding to be available on individual loans. (This figure should relate to the maximum loan ceiling being proposed.)
- Possible lending terms to be provided by participating lenders, including interest rates and repayment periods. (This statement should be presented in a manner which does not preclude negotiations on the issue if lenders do not accept the public agency's viewpoint.)
- Credit standards and procedures for credit processing. (The public agency should either leave this to lender determination or indicate that this is subject to further discussion. Officials seeking a definitive change in lender credit standards might deal with this issue in meetings with financial institutions rather than trying to describe their objectives in a written presentation.)
- Lender role in program policy. (Financial institutions must be assured that each participating lender will have the opportunity both to influence the final program guidelines and to play an ongoing policy recommendation role.)

The Negotiation Process

As public officials prepare for discussions, they should be sensitive to different attitudes and should expect a cooperative financing relationship to be established. Any eventual agreement must be consistent both with public objectives and with lender investment policies. Using this basic approach as a framework, public officials should take the following steps:

1) *Identify Private Sector Lending Institutions.*

Public agencies should compile a list identifying all commercial banks, savings banks, savings and loan associations, credit unions, mortgage banking companies, and insurance firms with real estate interests serving the municipality and the surrounding region. The chief executive officers of each institution and their addresses should be included in the listing as the key contacts for future communications

Although a partnership with one or two lenders may seem simplest to develop, public officials have found positive results when they involve all local institutions at the beginning. The more lenders who eventually agree to participate, the more funds will be available, and the more sympathetic each institution is likely to be in its processing of program loans. Furthermore, when a group of lenders is involved, program officials can refer individual applications to whichever institution has the most appropriate credit guidelines.

Mutual subsidy programs that involve lender interest rate reductions have mostly occurred where a minimum of three or four institutions have been involved. Since demands on individual lenders are reduced as a result of the multi-institutional participation, bank officials are more willing to commit special terms on program loans.

2. *Develop Initial Private Sector Support.*

Prior to calling a general meeting of all financial institutions, public officials should obtain support from one or more influential lending executives. Informal meetings with these officials give the public agency a chance to discuss its plans, obtain recommendations on guidelines, and get lender advice on gaining broader financial institution support.

A private sector official involved in the initial discussions may be willing to convene a general meeting and perhaps preside over it. The presence of informed and sympathetic lender representatives at the first formal meeting lends credibility to the plans of the public agencies.

3) *Formally Present the Agency Program*

Appropriate financial institutions should be invited to a formal meeting to discuss local CDBG rehabilitation efforts. Copies of the written proposal should be sent out with the meeting announcement at least 10 days before the presentation

The local chief executive (e g , the mayor or city manager) should welcome the private sector representatives and emphasize the government's interest in the preservation effort. Agency staff members should then review their current and projected rehabilitation efforts, emphasizing the proposed lender role, and answer any questions which may arise The last half of the meeting should be reserved for the lenders to discuss specific issues among themselves. In many leveraging negotiations, public officials offer to leave the meeting room at this point, waiting nearby in case additional questions arise. Since leveraging negotiations are difficult to complete unless supportive private sector leadership emerges, it is to be hoped that such leadership will have developed by this stage

4) *Schedule Additional Discussions*

Leveraging negotiations should have a definitive timeframe. The public agency ought to propose a commitment target date at the initial presentation, remaining prepared to adjust this date if lenders ask for more time to brief other officials or boards of directors. They may also wish to hold follow-up discussions with the other private sector representatives In many instances successful leveraging agreements have developed after a series of meetings has been held. Additional discussions with both individual institutions and with groups of lenders have brought successful adjustments in proposed local guidelines. Issues frequently negotiated include the type of mechanism to be used to combine public and private funds, and lending terms on loans and mortgages for program applicants

5) *Offer Lump-Sum Deposits to Gain Concessions on Loan Terms*

Leveraging agreements negotiated without the use of lump-sum deposits demonstrate that local officials do not always need to make such offers to gain lender participation, even where interest rates are reduced. However, certain public and private objectives may be met through such a commitment of funds up front. If public agencies wish to deposit a portion of their CDBG funds in return for special private sector considerations, this issue should be raised after the initial framework for institution commitments has been established When lenders raise the issue of deposits, public officials should delineate the special benefits which must be provided in return for such deposits In either case, public officials should review the HUD regulations included in the Appendix and clarify questionable points with the local HUD Area Office.

6) *Negotiate Final Commitments.*

Lender commitments should be made in writing, including the dollar amounts, a time period (if applicable), lending terms, any additional conditions, and designation of a specific official who will work with the public agency on a daily basis. Public officials should meet with lender contact persons, individually or in a group, to work out final processing details before the leveraging agreement becomes operational.

Convincing Lenders to Participate

Public officials may need to persuade reluctant lenders of the advantages of participating in a leveraging arrangement The following list summarizes arguments that can be used by public officials in seeking lender involvement.

1) *Property Improvement Lending Is A Safe Investment*

Most applications referred to lenders by CDBG agencies operating leveraging programs are for property improvement loans. Since the mid-thirties, the nationwide default rate on property improvement lending has been less than 2 percent of total loan volume, the lowest of any type of private sector obligation. This rate is as low or lower in CDBG rehabilitation programs. For example, the Municipal Home Improvement Project of Hoboken, New Jersey, has operated a leveraged loan program utilizing private sector insured and uninsured improvement lending since 1972. This program has forwarded 600 loan applications with a total value of nearly $5 million to cooperating lenders. There have been no defaults and only 5 cases of delinquencies. The experience is similar in other parts of the country.

The absence of repayment problems in leveraging programs is not surprising, and other agencies should anticipate similar results Loan applications are sent to lenders only after property owners agree to meet detailed eligibility requirements, rehabilitation standards, and program cost guidelines. This procedure guarantees that owners proceeding to the loan approval stage are highly motivated and committed to repayment.

Finally, owner motivation is reinforced by the on-going commitments that public agencies have to the CDBG rehabilitation programs. Delinquencies (where they occur) are detected quickly, and public agency staff can counsel owners with payment problems. Such personal attention serves to reduce or eliminate defaults

2) *Public Agencies Add New Dimensions to Traditional Lending.*

Each leveraged loan application undergoes intensive review by the CDBG agency technical personnel. Financial counselors determine income eligibility, offer assistance to owners in computing present and future property cash flow, and prepare loan or mortgage application forms submitted to the lender.* Rehabilitation specialists visit the structures needing improvement, list priority repairs, compile rehabilitation specifications and cost estimates, and supervise construction progress. Sometimes staff members also help property owners choose contractors.

These specialized processing services by local agencies are a significant incentive for private sector participation in the public programs. In traditional lending, few of these services can be performed. For example, once a normal property improvement loan is approved, few institutions monitor construction. Property appraisals on mortgages provide some control over rehabilitation costs, but lenders lack the staff to establish standard improvement charges for repairs.

*Since lenders will insist on doing their own credit checks on individual cases, public agency staff do not usually perform credit reviews.

In contrast, by participating in leveraging programs with local agencies, lending institutions are able both to monitor the quality of the rehabilitation work performed and to have some influence on the cost of work. Lenders receive protection on their own investment and have assurance that their funds will have maximum positive effect on the structures being upgraded

3) *CDBG Rehabilitation Brings New Investment Opportunities for Lenders*

Whether or not actual redlining has occurred in target areas, most of the low- and moderate-income property owners are unable to afford private sector loans and mortgages at market interest rates. With public subsidies reducing the effective interest levels and monthly payment on lender financing, a number of new borrowers will be applying for loans or mortgages The level of interest in new financing can be further stimulated by marketing efforts to convince neighborhood residents to participate in the CDBG program.

4) *Private Investments Are An Integral Part of Neighborhood Preservation Programs.*

Through leveraging agreements, lenders can invest in existing residential and commercial properties as part of a comprehensive neighborhood preservation strategy, rather than in a haphazard one. The private sector loans and mortgages will be supported by specific public improvements The comprehensive approach provides protection for investments As neighborhood upgrading proceeds and interest in new homeownership increases, lenders can make purchase mortgage commitments to safeguard their stake in the area.

5) *Public Agencies Answer Questions on Program Guidelines and Individual Lending Decisions.*

Lenders who participate in leveraging efforts provide financial support for public programs developed by local government agencies. Since the programs are established by public officials, questions on loan and mortgage terms, income and ownership eligibility requirements, geographic restrictions for CDBG programs, and any other inquiries (or disputes) are handled by the government agency

Chapter 7

Conclusion

Adoption of a leveraged loan program as part of a comprehensive rehabilitation financing plan can offer substantial benefits to public agencies and to the citizens they are serving. If government officials are willing to follow the complex process of program development and lender negotiation, they can develop meaningful partnerships with private financial institutions. The loan resources resulting from this cooperation can produce significant rehabilitation financing tools.

Public-private cooperation in rehabilitation financing is a young field; the approaches described here for combining public and private funds represent only the first stage in its development. Undoubtedly, new and more effective models will be developed as officials around the country work together gaining additional experience.

The needs of local projects will change with time. Public and private sector officials engaged in a cooperative venture should meet periodically to review program progress and to modify joint financing arrangements. Through such discussions, participants will have opportunities to discuss new leveraging approaches being developed elsewhere and to consider implementing new models in their own communities.

Appendices

Appendix I

Basic Loan and Mortgage Types: Major Characteristics

	Property Improvement Loans	Mortgages	Business Loans
Eligibility: conventional	Improvements and additions to existing residential structures; not purchase or refinancing of new construction (in most States)	Purchase of new or existing structures; rehabilitation, or refinancing of small (1-4 unit) residential property, and commercial property.	Physical improvements, replacement of or additions to inventory.
federally-insured or guaranteed	Same general characteristics, but may include some supportive new construction and improvements to commercial or mixed-use buildings	HUD-FHA: small and multifamily residential properties. VA: small residential properties.	Small Business Administration (SBA): As above, and – to acquire land, inventory, working capital construction or acquisition of buildings; no speculation allowed.
Lending Ceilings: conventional	Generally $10,000 (possible range of $5,000 to unlimited amounts).	1st. no statutory limits: lending ceiling based on appraisal 2nd: limited by some institutions to $10,000-$20,000	Open-ended, in excess of $100,000.
federally-insured or guaranteed	$15,000 for one-unit property Up to $25,000 for multi-unit structures, but no more than $5,000 per unit	HUD-FHA: $60,000 on 1-4 unit structure. $37,000 per DU on multifamily structures. VA: lender sets ceiling.	SBA: Direct loans – $150,000 to single business. Loan guarantees to private lenders – 90% of loan or $500,000, whichever is smaller.
Repayment Terms: conventional	Usually 7-10 years, longer in a few States	1st: normally, 25-30 years. Less by some lenders in case of urban area purchase or rehabilitation.	5-10 years; if insured by the SBA, can be 20-25 years.
federally-insured or guaranteed	15 years	HUD-FHA: 30 years	SBA: For land or building – 20 years; for equipment – 10 years; for working capital – up to 10 years; or combination.

Basic Loan and Mortgage Types: Major Characteristics (Continued)

	Property Improvement Loans	Mortgages	Business Loans
Interest Rates: conventional	10-14%, depending on State and lending institution	1st: Residential – 9½%-11% depending on State, commercial – 9-15% depending on applicant's credit standing, local variations, and type of institution 2nd: residential uses only, 9-14%.	9-13%, depending on individual credit standing
federally-insured or guaranteed	Ceiling of 12%, including a ½% premium paid by lender to HUD-FHA	HUD-FHA. Currently 9½% VA. Currently 9½%.	SBA: Direct loans – 7⅜% for Fiscal Year 1979 Loan guarantees – lenders may charge up to 12%.
Paperwork Required:	Limited to application, income tax return, and either a contractor's estimate or owner's material listing.	Must include sales documents, income tax records, verification of assets and obligations, property title search and evidence of filing of titles, proof of title, insurance, contractor's estimate or owner's material listing, completed security and rate form	Owner's profit and loss statement
Processing Time: conventional	About one week.	About 2-4 weeks	
federally-insured or guaranteed	About one week, except for obligations of $15,000 or more which takes about four weeks for HUD Area Office to review	FHA And VA: 2-3 months for small properties: about 4-6 months on FHA mortgages and multifamily structures.	SBA: From 3 to 60 days depending on type of loan

Basic Loan and Mortgage Types: Major Characteristics (Continued)

	Property Improvement Loans	Mortgages	Business Loans
Payment of Proceeds: conventional	Lenders pay either before or after repairs; progress payments may be made by public officials using own funds or after loans placed in escrow. Repayment begins 30-45 days after owner receives initial check.	Lenders provide for payment schedules based on completion of portions of work.	At approval of loan.
federally-insured or guaranteed	Same as above	FHA and VA: provide for payment of entire mortgage proceeds at closing; in rehab this means that owner does not generally receive funds until all work is complete.	
Downpayments: conventional	None.	20-30% of total financing costs for purchase and/or rehabilitation.	None.
federally-insured or guaranteed	None.	FHA-VA: 10% or less of total cost.	
Fees: conventional	Credit processing = $15-$20 When a lien is placed, filing fees and limited title search charges may reach $75. Legal services are not required.	For a $20,000 mortgage, ranges from $200-$300. Higher mortgages will involve proportionately higher costs. Includes credit review, title search and filing fee, property appraisal cost, legal expenses on closings. Borrowers must also place a year's funds in escrow.	None.
federally-insured or guaranteed	Supplemental charges limited by regulations. In Title I, lender must pay ½% insurance fee based on the declining balance.	HUD-FHA-VA: up to 2% of the total mortgage value. Borrower must also pay ½% insurance fee based on the declining mortgage balance.	Limited, similar to property improvement.

Basic Loan and Mortgage Types: Major Characteristics (Continued)

	Property Improvement Loans	Mortgages	Business Loans
Basis For Approval: conventional	Based on borrower's ability to repay. Credit formula compares an owner's total housing costs. (Allowable ratio of 30-50%.) Property appraisals not a factor.	Credit formula similar to those for property improvement loans, and appraised standard: 70-90% of appraised property value allowable on uninsured first and refinanced mortgages. With private insurance, 90-95% of value can be borrowed. 2nd mortgage: total value of both obligations cannot exceed relevant percentage of appraisal limit.	Appraisals not generally a factor; decreases based on borrower's ability to repay.
federally-insured or guaranteed	Same as above.	HUD-FHA-VA: generally, allow higher percentage of appraised value than conventional lenders.	
Lending Sources:	Commercial Banks	Commercial banks (first residential mortgages primarily).	Commercial banks
	Savings Banks	Savings banks (1st and 2nd residential and some commercial mortgages).	
	Savings and Loans Associations	Savings and Loan Associations (1st and 2nd residential mortgages.)	
	Credit Unions	Credit Unions (mortgages).	

Appendix II

Basic Loan and Mortgage Types: Major Advantages – Disadvantages

Property Improvement Loans	Mortgages	Business Loans
Advantages		
1 Lending ceilings high enough for small residential and commercial rehab	1. Higher lending ceilings, which are essential for rehabilitation or multifamily structures	1 Unlimited lending ceilings.
2 Processing time is short	2 Longer repayment terms	2. Willingness of financial institution to place loans as second obligations.
3 Loan fees are minimal	3. Lower market interest rates	3 Applicant's ability to use part or all of proceeds for fixtures and inventory.
4. No need for appraisals	4. Possibility of including refinancing of existing obligations.	
Disadvantages		
1 Lower lending ceilings	1. Dependence on appraisals	1 Shorter repayment terms.
2. Shorter repayment terms.	2 Lender inexperience in using mortgage	2. Higher interest rates. lending for rehabilitation.
	3. High market interest rates.	3. Higher processing fees.
		4. Extra processing time and paperwork, particularly for insured mortgages.

Appendix III

Preparing a 3-5 Year Rehabilitation Financing Plan

Local officials should consider the following methodology in estimating future rehabilitation financing needs·

1. **Number of Structures**

For each of the proposed Neighborhood Strategy Areas (NSA's), identify the number of residential structures in each size category, i.e., 1-2 unit, 3-4, etc.

If spot rehabilitation is to take place outside the concentrated areas, the public agencies will have to estimate the number of properties in each size category which are owned by potential income eligible applicants.

2. **Property Condition Analysis**

Not all of the properties identified in Step 1 require rehabilitation activity, and some structures may be more appropriate for demolition. Also, properties appropriate for rehabilitation require varying levels of repairs.

Local agency rehabilitation specialists and/or code enforcement personnel need a comprehensive property condition analysis of the structures. Windshield surveys, i.e., exterior inspections, are sufficient for this task. When a community has detailed code inspection records and/or staff resources to do spot inside inspections, the condition analysis is even more meaningful. Within each size category for all the NSA's and the proposed spot rehabilitation buildings, properties should be categorized into four or more groups, including: (1) maintenance activity, (2) light to moderate repairs, (3) moderate to heavy rehabilitation, or (4) suitable for demolition.

3. **Maximum Rehabilitation Financing Needs**

Structures similar in size and improvement needs to the properties previously assisted by the public rehabilitation program will require per unit repair costs generally similar to the average on earlier projects. (These have usually been 1-4 unit properties requiring light to moderate rehabilitation.) Average costs should be adjusted to reflect inflationary conditions and any proposed adjustments in program guidelines. An inflation figure of 20 percent for three year projections or 30 percent on five year plans is not unrealistic. If a program is shifting from the exclusive use of grants to leveraged loans, a 30 percent increase in the previous per dwelling unit costs can be anticipated. Also, the local agencies should make appropriate adjustments if a proposed change from direct to leveraged loans will result in an increase in overall loan limits and for guideline adjustments increasing the percentage of allowable general improvements.

These modified figures, when multiplied by the number of units in similar properties, yield a projected **maximum** rehabilitation figure for this property group If a municipality has had significant differences in per unit costs for different-sized structures, several distinct computations may be necessary.

To compute the projected costs for rehabilitation efforts on structures requiring more improvements than the initial phase properties, officials need a separate estimate of per dwelling unit charges Data on rehabilitation costs for comparable structures may be available from neighboring municipalities already working with the more deteriorated structures. Otherwise, local staff may need to prepare a few work descriptions and cost estimates on representative structures to establish an average cost. This estimated figure can be multiplied by the number of units in the moderate to heavy rehabilitation need category identified in Step 2.

Local officials can obtain a reasonable estimate of future maximum rehabilitation financing needs in their projected NSA and spot rehabilitation efforts by adding together these two sets of computations

4. **Financing Demands on the CDBG Program**

This computed figure does not reflect all financing demands made on the public rehabilitation programs. To determine a reasonable estimate of needs, the following adjustments should be made:

a) For smaller properties located in NSA's requiring light to moderate improvement activity, assume that no more than 50 percent of these structures will be rehabilitated with public assistance.

As part of the overall NSA upgrading process 20-30 percent of the owners can be expected to improve their structures with their own funds, and the remaining percent of the property is likely to be left basically untouched, at least during the 3-5 year period being considered here.

b) Add 10-20 percent to the estimate when the local agency proposes loan guidelines permitting NSA or municipality-wide owners to use funds for general improvements.

c) On spot rehabilitation activity, assume that no more than 25 percent of the eligible owners will apply for public financing.

d) For the larger, more deteriorated structures, determine the cut-off point for rehabilitation projects to be financed with local program funds Although municipalities planning a new focus on these types of properties ought to consider appropriate increases in the financing limits allowed under program guidelines, CDBG resources are finite and cannot support all heavy rehabilitation activity * Section 312 loans, with $27,000 per dwelling unit cost limits, and the Section 8 substantial rehabilitation program, providing generous subsidy of tenant rents and permitting extensive rehabilitation costs, are for financing the larger scale projects

Once a cut-off has been determined, the properties with rehabilitation needs suitable for CDBG support can be identified and the projected financing demand computed by multiplying the average estimated cost per dwelling unit derived in Step 3 by the number of apartments in the appropriate structures Actual publicly-assisted rehabilitation activity should require about 40 percent of this figure.

Having completed these adjustments, public agencies should have a reasonable estimate of future financing demands on their CDBG rehabilitation programs. Using leveraged loans, requiring only a portion of rehabilitation costs to be paid from public funds, local agencies are likely to consider higher overall limits than if 100 percent CDBG funds are involved

*Even with the aggressive use of code enforcement, it is doubtful that a larger percentage of the more deteriorated structures will be upgraded during the next 3-5 years Many of these properties are absentee owned and may require ownership changes before they are improved Additional upgrading should take place once the initial neighborhood revitalization cycle is well underway

Appendix IV

Impact of Interest Rates and Repayment Terms On Leveraging Ratios

Assumptions. $20,000 loan

10% return to lender

Subsidy on Present Value

Below-Market Terms Interest/Repayment		Private Funds	Public Funds	Monthly Payment	Percent of Public/Private	Leverage Ratio
1%	5 yrs.	$16,071	$ 3,929	$340.60	19.7%	5 1-to-1
	10 yrs.	13,212	6,788	174.60	33.9%	2 9-to-1
	15 yrs.	11,130	8,870	119.60	44 4%	2 3-to-1
	20 yrs.	9,574	10,426	92.40	52 1%	1.9-to-1
3%	5 yrs.	$16,911	$ 3,089	$359.30	15.5%	6.5-to-1
	10 yrs.	14,613	5,387	193 13	26.9%	3.7-to-1
	15.yrs.	12,851	7,149	138.10	35 8%	2.8-to-1
	20 yrs.	11,493	8,507	110.92	42.5%	2.4-to-1
5%	5 yrs.	$17,764	$ 2,236	$377 43	11.2%	8 9-to-1
	10 yrs.	16,076	3,924	212.14	19.6%	5 1-to-1
	15 yrs.	14,717	5,283	158.16	26 4%	3 8-to-1
	20 yrs.	13,678	6,322	132 00	31.6%	3.2-to-1
7%	5 yrs.	$18,640	$ 1,360	$396.13	6 8%	14 7-to-1
	10 yrs.	17,572	2,428	232.22	12.1%	8 2-to-1
	15 yrs.	16,738	3,263	179 77	16.3%	6.1-to-1
	20 yrs.	16,067	3,933	155.06	19 7%	5.1-to-1

Appendix V

HUD Lump-Sum Deposit Regulations

Federal Register / Vol. 44, No. 68
Friday, April 6, 1979 / Rules and Regulations

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Office of the Assistant Secretary for Community and Planning Development

24 CFR Part 570

Community Development Block Grants (CDBG); Grant Administration Requirements for Lump Sum Drawdown of CDBG Funds for Property Rehabilitation Financing

AGENCY: Department of Housing and Urban Development (HUD).

ACTION: Final Rulemaking.

SUMMARY: This final rule establishes the conditions under which a Community Development Block Grant recipient may draw in one sum funds designated in its Community Development application for the establishment in a private financial institution of a fund for the purpose of financing the rehabilitation of privately-owned property.

EFFECTIVE DATE: May 7, 1979.

FOR FURTHER INFORMATION CONTACT: Leonard J. Czarniecki, Rehabilitation Policy Division, Office of Urban Rehabilitation and Community Reinvestment, Department of Housing and Urban Development, Washington, D.C. 20410 (202) 755-6300.

SUPPLEMENTARY INFORMATION: On August 3, 1978, (43 CFR 34424) proposed revisions to 24 CFR Part 570 were published in the **Federal Register** for public comment. Interested parties were given until September 5, 1978, to submit written comments. All comments received with respect to the proposed rules governing the grant administration requirements for the lump sum drawdown of Community Development Block Grant (CDBG) funds for property rehabilitation financing were given due consideration.

As a result of the comments received the following changes were made:

Basic Requirements

The first sentence of § 570.513 has been revised as a result of comments indicating the need to provide that a block grant recipient may draw funds from the letter of credit in single lump sum to establish a rehabilitation fund in one or more private financial institutions for the purpose of financing the rehabilitation of privately owned properties (including residential, mixed use, and nonresidential properties) and the private acquisition of properties for rehabilitation as a part of the recipients' community development program.

Section 570.513(a) which contains key definitions used in the regulation has been amended in response to comments to include clarifying language for "private funds" and a definition for "rehabilitation". Private funds can include funds held in trust for the benefit of bondholders or noteholders of the CDBG recipient or its agency where such bond or note proceeds are to be used in connection with the rehabilitation financing program. The definition of "private financial institution" was amended to make clear that savings and loan associations, credit unions and other financial institutions, in which deposits are federally insured, are eligible depositories for the rehabilitation fund. The definition of "rehabilitation" expands the use of the fund authorized by § 570.513(c) to include the financing of private entities (both those organized for profit and also those on a not for profit basis) to acquire private properties for rehabilitation, and the rehabilitation of commercial and industrial buildings and structures pursuant to § 570.203(c)(1). This change is in accord with the activities eligible for financing under Section 105(a)(4) of the Housing and Community Development Act of 1974 as amended, as implemented by § 570.202(c)(1) of the regulations.

Section 570.513(b) has been revised to make clear that the two year limit on the written agreement only limits the period during which new loans may be made. The agreement will necessarily have to cover a longer period in most cases. For example, an agreement calling for a lump sum drawdown of funds to be used to guarantee rehabilitation loans made by the private financial institution(s) would have to run as long as the private rehabilitation loans, i.e., the agreement must require the block grant recipient to leave some funds on deposit until the private rehabilitation loan is fully repaid, which may take 20 years.

Section 570.513(c) has been amended in response to comments to make clear that the rehabilitation fund can be used as reserves and to pay issuance or administrative costs in connection with the issuance of bonds or notes by the block grant recipient or its agency, where such bond or note proceeds are to be used to fund rehabilitation loans or grants.

Several comments were received on § 570.513(d). All comments expressed concern with the requirement that "rehabilitation loans made with such private funds shall be subject to the same requirements as are applicable to direct loan or grant assistance provided for the rehabilitation of private property under this Part". This is not a new requirement resulting from the enactment of the drawdown authority, since authority to use block grant funds as subsidies or guarantees in connection with private loans has always been in the CDBG regulations.

To the extent that private loans are effectively intermingled with CDBG funds, e.g., through use of CDBG for interest subsidies or loan guarantees, it has always been true that the use of the private funds has been governed by the CDBG rules on use of CDBG funds. For example, such loans could not be made in a racially discriminatory manner or avoid labor standards requirements of the Davis-Bacon Act, as amended. Specific concerns of the commenters centered on the procurement

requirements of the Office of Management and Budget Circular No. A–102 dated September 12, 1977, which superseded Federal Management Circular 74–7. However, the Department has determined that the procurement standards (Attachment O) of the foregoing circular ordinarily applicable to CDBG assisted construction activities do not apply to the contracting for services and materials by private parties who make use of rehabilitation assistance offered by the grant recipient, where the contract is not entered into by the grant recipient, itself. This means that the procurement of the necessary work and material is done at the instance and for the benefit of the private owner. Although formal competitive bidding is therefore not required, all procurement transactions, regardless of whether negotiated or advertised, should be conducted in a manner which encourages open and free competition. It should also be noted that the requirements of the Davis-Bacon Act are applicable to the rehabilitation of residential property pursuant to Section 110 of the Housing and Community Development Act of 1974, if such property is designed for residential use of eight or more families.

Quite a number of comments were received on § 570.513(e), which prescribes a 45 day time limit on the start of use of deposited funds. Commenters requested that the time limit be extended to 60 or 90 days. The 45 day limit was prescribed by statute in Section 104(i)(1) of the Housing and Community Development Action of 1974, as amended by the 1977 Act (Pub. L. 95–128) and cannot be amended by regulation.

Several comments on § 570.513(f) related to a lump sum deposit made by the block grant recipient for the purpose of establishing a fund to guarantee privately financed rehabilitation loans. The clarifying language added to § 570.513(b) regarding block grant funds used to guarantee rehabilitation loans made by the private financial institutions is responsive to these concerns.

One commenter on § 570.513(g) recommended that, as with any program income, the interest earned on the rehabilitation fund be used for any eligible community development activity. This change was not made because this requirements is based on the statutory provision (Section 104(i)(2)(D) that "interest earned on such cash deposits shall be used in a manner which supports the community rehabilitation program."

HUD Area Office Approval

Section 570.513(h) received the most comments. Commenters were very concerned about the timing requirement for the submittal of requests for a lump sum drawdown. In response to these comments, this section has been changed to permit HUD Area Offices to accept these requests for review and approval any time during the program year. Generally, HUD review will be carried out as a part of the review and approval of a block grant application but requests for a lump sum drawdown will be accepted throughout the program year to preclude delay in the establishment of local rehabilitation funds. Accordingly, Paragraph (h) of § 570.513 has been modified.

Several comments were received on § 570.513(i). Some of the most comprehensive comments on this section raised questions about terminology e.g., "below market rate," "longer repayment period" and "higher risk." These are terms which are contained in the statutory provision 104(i) and serve as the basis for these rules. The provision contained in § 570.513(i)(1) that private financial institutions may satisfy the benefit criteria by committing private funds for the rehabilitation financing activities in amounts which are substantially in excess of the deposit of block grant funds is also based on language contained in Section 104(i). The final regulations continue to use the language prescribed in the statute. One change that has been made in this section in response to a comment is to direct HUD Area Offices to encourage block grant recipients to use minority banks (a bank which is owned at least 50 percent by minority group members). This is consistent with the national goal of expanding the opportunities for minority business enterprises. A list of minority owned banks can, be obtained from the Office of Minority Business Enterprise, Department of Commerce, Washington, D.C. 20230.

Several commenters were concerned with the benefit tests prescribed in Paragraph (i) when market rate interest is not payable on the rehabilitation fund. The tests require an estimate of foregone interest, and a quantified estimate of the value of the benefits of the commitment under the agreement. The Department recognizes that these requirements will require carefully considered estimates of value by the block grant recipient and the participating financial institutions, but the Department considers that such economic analysis is needed to meet the requirements when interest is not earned on deposited funds. Accordingly, changes in paragraphs (i)(2)(A) and (i)(2)(B) were not made at this time.

Comments Not Acted Upon

The description of the changes to § 570.513 discussed several comments which HUD was unable to act upon. In many cases, comments proposed the inclusion or modification of activities not authorized by the statute or the exclusion of activities which were specifically authorized. Other comments proposed alternative directions on matters of Departmental policy which after due consideration were not accepted.

The following are some of the comments already discussed which HUD did not agree to act upon for the reasons set forth above:

1. Eliminate the requirement that where the rehabilitation fund or other block grant assistance is used to subsidize or guarantee the payment of rehabilitation loans made with private funds, or is used to provide a supplemental loan or grant to the borrower of private funds, the rehabilitation loans made with such private funds shall be subject to the same requirements as are applicable to direct loan or grant assistance provided for the rehabilitation of private property under this part.

2. Extend the 45 day time limit on the start of use of deposited funds to 60 or 90 days.

3. Use the interest earned on the rehabilitation fund for any eligible community development activity.

4. Eliminate use of certain terms, e.g., "below market rate." One commenter recommended that the Department support a proposal to amend the Housing and Community Development Act to authorize State Housing Finance agencies to be an eligible financial under § 570.513.

Several comments were received on the needs of small rehabilitation contractors who require prompt payment for work completed because of cash flow problems. These included recommendations to establish a rehabilitation fund under § 570.513 for this purpose. Although the timely payment of small contractors is a very important element of a local rehabilitation financing activity, the primary purpose of establishing a rehabilitation fund in private financial institutions is generally designed to assure the leverage of community development block grant funds so that participating financial institutions commit private funds for loans in the local rehabilitation program in amounts in excess of deposit of community development funds.

OTHER INFORMATION: A Finding of Inapplicability with regard to Environmental Impact has been prepared in accordance with HUD Handbook 1390.1. Copies of the statement and findings are available for inspection and copying during business hours in the Office of the Rules Docket Clerk, Room 5216, Department of Housing and Urban Development, 451 Seventh Street, S.W., Washington, D.C. 20410.

Accordingly 24 CFR 570 is amended as follows:

1. Section 570.503 is revised to read as follows:

§ 570.503 Cash withdrawals.

(a) Except as provided in § 570.513, which covers lump sum drawdowns for financing the rehabilitation of privately owned properties, the timing and amount of cash withdrawals from the U.S. Treasury by the recipient for activities which are free from all conditions specified pursuant to §§ 570.311 or 570.433(b)(2) shall be in accordance with U.S. Department of the Treasury regulations on withdrawal of cash from the Treasury for advances under Federal programs (31 CFR part 205), as incorporated in HUD handbook 1900.23 Rev., Letter of Credit Procedures—Treasury Regional Disbursing Office System.

(b) To the maximum extent practicable, program income shall be disbursed prior to making additional draws from the letter of credit to finance approved community development activities (including local option activities) as follows:

(1) Program income in the form of repayments to a revolving fund, other than a fund to finance the rehabilitation of privately owned properties as provided for in § 570.513, established to carry out an approved activity, shall be substantially disbursed from such fund before additional draws are made from the letter of credit for the same activity.

(2) All other program income shall be substantially disbursed for any approved activity before additional draws are made from the letter of credit.

2. § 570.513 is added to read as follows:

§ 570.513 Lump sum drawdown for property rehabilitation financing.

Subject to the conditions prescribed in this section recipients of grants under this Part may draw funds from the letter of credit in a single lump sum to establish a rehabilitation fund in one or more private financial institutions for the purpose of financing the rehabilitation of privately owned properties as a part of the recipient's community development program.

(a) *Definitions.* (1) "Rehabilitation fund" means a fund established with block grants drawn down in a lump sum from the recipient's letter of credit for use in a rehabilitation financing program under the terms of an agreement between the block grant recipient and the depository private financial institution pursuant to the requirements of this section. (2) "Private financial institution" means a depository (including banks, savings and loan associations, credit unions and other financial institutions), in which deposits are federally insured, and which is a party to such an agreement. (3) "Private funds" means the funds of the private financial institution. Private funds include funds held in trust for the benefit of bondholders or noteholders of the CDBG recipient or its agency where such bond or note proceeds are to be used in connection with the rehabilitation program. (4) "Rehabilitation" means the activities eligible for rehabilitation of properties pursuant to § 570.202(c), including the acquisition of properties for rehabilitation by private entities organized for profit or on a not-for-profit basis, and the rehabilitation of commercial and industrial buildings and structures pursuant to § 570.203(c)(1).

(b) *Requirement for agreement.* A written agreement for the deposit of block grant funds to establish a rehabilitation fund shall be executed by the block grant recipient and participating private financial institution(s). The agreement shall specifically describe the obligations and responsibilities of the parties and the terms and conditions on which such funds are to be deposited and used consistent with the requirements of this section. Except as may otherwise be authorized by the HUD Area Office in connection with approvals for uses of the rehabilitation fund pursuant to paragraph (c)(5) or (7), the agreement shall authorize the use of the rehabilitation fund only in connection with grants and loans made within a period of two years from the date of the agreement. The description of the proposed use of deposited funds in the agreement shall include a statement on the intended use of loan repayments and interest earned. The agreement shall expressly provide that its terms and conditions are subject to the provisions governing lump sum drawdowns for property rehabilitation § 570.513 of the HUD regulations on community development block grants, 24 CFR Part 570.

(c) *Uses of rehabilitation fund.* The rehabilitation fund may be used for the following purposes:

(1) To make direct rehabilitation loans or grants to property owners;

(2) To pay interest subsidies, or establish a fund for payment of subsidies, on rehabilitation loans made by private financial institutions with private funds;

(3) To guarantee the repayment of rehabilitation loans made to property owners by private financial institutions with private funds; or

(4) To serve as collateral for financing actually extended to the applicant (or applicant's agency) where such financing is used to make rehabilitation loans or grants.

(5) To fund reserves and/or pay issuance or administrative costs in connection with the issuance of bonds or notes by the recipient or its agency, where such bond or note proceeds are to be used to fund rehabilitation loans or grants.

(6) For the payment of reasonable administrative fees and charges of the private financial institution related to the provision of financing for the rehabilitation of private property; or for

(7) Other uses as may be approved by HUD consistent with the objectives of this section.

(d) *Rehabilitation loans made with private funds.* Where the rehabilitation fund or other block grant assistance is used to subsidize or guarantee the payment of rehabilitation loans made with private funds, or is used to provide a supplemental loan or grant to the borrower of the private funds, the rehabilitation loans made with such private funds shall be subject to the same requirements (excluding the treatment of loan repayments as program income) as are applicable to direct loan or grant assistance provided for the rehabilitation of private property under this Part.

(e) *Time limit on start of use of deposited funds.* Use of the deposited funds for rehabilitation financing assistance (e.g., first loan is made, subsidized or guaranteed) must start within 45 days of the deposit. Should use of deposited funds not start within 45 days, the recipient may be required by HUD to return all or part of the deposited funds to the letter of credit.

(f) *Return of unused deposits.* At the termination of the period of the agreement, all unobligated funds (funds of the rehabilitation fund that have not been encumbered or disbursed) then on deposit shall be returned to the recipient's letter of credit unless the block grant recipient has been or is being authorized by HUD to extend the agreement for an additional period. In addition, the block grant recipient shall reserve the right to withdraw from the rehabilitation fund any unobligated amounts required by HUD in the exercise of corrective or remedial actions authorized under § 570.910(b) of the regulations.

(g) *Interest earned on the rehabilitation fund.* Interest earned on the rehabilitation fund shall be used pursuant to the terms and conditions of the agreement consistent with the uses authorized under paragraph (c) of this section.

(h) *Request for HUD review and approval of lump sum drawdown.* HUD area office review and approval of a request for a lump sum drawdown is required prior to drawdown. HUD review can be carried out anytime during the program year but generally HUD will review these requests as a part of the review and approval of a block grant application except those requests submitted in conjunction with grants made under the Secretary's fund for new communities. A request submitted in connection with the new communities fund is subject to the requirements of this section; however it shall be reviewed and approved by the New Communities Development Corporation, which approves and administers grants under the new communities fund. All requests for drawdown shall include:

(1) A copy of the written agreement described in paragraph (b);

(2) The reasons for the locality's belief that the agreement meets the HUD approval standards set forth in paragraph (i); and

(3) Certification, described in paragraph (i)(2)(i); where the request proposes that the benefit to be derived from lump sum drawdown qualifies under paragraph (i)(2)(i).

(i) *HUD review criteria for approval of lump sum drawdown request.* The HUD area office shall approve a request for lump sum drawdown if it determines that the funds will be deposited in one or more private financial institutions under an agreement which includes, one or more of the commitments described in paragraph (i)(1) of this section; meets the benefit tests described in paragraph (i)(2) of this section; meets the tests concerning the amount of drawdown described in paragraph (i)(3) of this section; and otherwise meets the requirements of paragraph (b) of this section. Consistent with the national goal of expanding the opportunities for minority business enterprises, the HUD area office shall encourage block grant recipients to use minority banks (a bank which is owned at least 50 percent by minority group members).

(1) *Commitments by private financial institutions.* (i) Commitment of private funds for the rehabilitation financing activities in amounts which are substantially in excess of the deposit of block grant funds;

(ii) Commitment of private funds for rehabilitation financing activities at below-market interest rates, or with longer repayment periods, or at higher risk than would normally be taken;

(iii) Provision of administrative services by the financial institutions in support of the rehabilitation financing activities at no cost or at reduced cost.

(2) *Benefit tests.* (i) *When market rate interest is payable on the rehabilitation fund*—When interest at the market rate for deposits of similar maturity and size is payable on the rehabilitation fund, the applicant must certify that the commitment under the agreement pursuant to paragraph (i)(1) provides a

3. Use the interest earned on the rehabilitation fund for any eligible community development activity.

4. Eliminate use of certain terms, e.g., "below market rate." One commenter recommended that the Department support a proposal to amend the Housing and Community Development Act to authorize State Housing Finance agencies to be an eligible financial under § 570.513.

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(b) To the maximum extent practicable, program income shall be disbursed prior to making additional draws from the letter of credit to finance approved community development activities (including local option activities) as follows:

(1) Program income in the form of repayments to a revolving fund, other than a fund to finance the rehabilitation of privately owned properties as provided for in § 570.513, established to carry out an approved activity, shall be substantially disbursed from such fund before additional draws are made from the letter of credit for the same activity.

(2) All other program income shall be substantially disbursed for any approved activity before additional draws are made from the letter of credit.

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§ 570.513 Lump sum drawdown for property rehabilitation financing.

Subject to the conditions prescribed in this section recipients of grants under this Part may draw funds from the letter of credit in a single lump sum to establish a rehabilitation fund in one or more private financial institutions for the purpose of financing the rehabilitation of privately owned properties as a part of the recipient's community development program.

(a) *Definitions.* (1) "Rehabilitation fund" means a fund established with block grants drawn down in a lump sum from the recipient's letter of credit for use in a rehabilitation financing program under the terms of an agreement between the block grant recipient and the depository private financial institution pursuant to the requirements of this section. (2) "Private financial institution" means a depository (including banks, savings and loan associations, credit unions and other financial institutions), in which deposits are federally insured, and which is a party to such an agreement. (3) "Private funds" means the funds of the private financial institution. Private funds include funds held in trust for the benefit of bondholders or noteholders of the CDBG recipient or its agency where such bond or note proceeds are to be used in connection with the rehabilitation program. (4) "Rehabilitation" means the activities eligible for rehabilitation of properties pursuant to § 570.202(c), including the acquisition of properties for rehabilitation by private entities organized for profit or on a not-for-profit basis, and the rehabilitation of commercial and industrial buildings and structures pursuant to § 570.203(c)(1).

(b) *Requirement for agreement.* A written agreement for the deposit of block grant funds to establish a rehabilitation fund shall be executed by the block grant recipient and participating private financial institution(s). The agreement shall specifically describe the obligations and responsibilities of the parties and the terms and conditions on which such funds are to be deposited and used consistent with the requirements of this section. Except as may otherwise be authorized by the HUD Area Office in connection with approvals for uses of the rehabilitation fund pursuant to paragraph (c)(5) or (7), the agreement shall authorize the use of the rehabilitation fund only in connection with grants and loans made within a period of two years from the date of the agreement. The description of the proposed use of deposited funds in the agreement shall include a statement on the intended use of loan repayments and interest earned. The agreement shall expressly provide that its terms and conditions are subject to the provisions governing lump sum drawdowns for property rehabilitation § 570.513 of the HUD regulations on community development block grants, 24 CFR Part 570.

(c) *Uses of rehabilitation fund.* The rehabilitation fund may be used for the following purposes:

(1) To make direct rehabilitation loans or grants to property owners;

(2) To pay interest subsidies, or establish a fund for payment of subsidies, on rehabilitation loans made by private financial institutions with private funds;

(3) To guarantee the repayment of rehabilitation loans made to property owners by private financial institutions with private funds; or

(4) To serve as collateral for financing actually extended to the applicant (or applicant's agency) where such financing is used to make rehabilitation loans or grants.

(5) To fund reserves and/or pay issuance or administrative costs in connection with the issuance of bonds or notes by the recipient or its agency, where such bond or note proceeds are to be used to fund rehabilitation loans or grants.

(6) For the payment of reasonable administrative fees and charges of the private financial institution related to the provision of financing for the rehabilitation of private property; or for

(7) Other uses as may be approved by HUD consistent with the objectives of this section.

(d) *Rehabilitation loans made with private funds.* Where the rehabilitation fund or other block grant assistance is used to subsidize or guarantee the payment of rehabilitation loans made with private funds, or is used to provide a supplemental loan or grant to the borrower of the private funds, the rehabilitation loans made with such private funds shall be subject to the same requirements (excluding the treatment of loan repayments as program income) as are applicable to direct loan or grant assistance provided for the rehabilitation of private property under this Part.

(e) *Time limit on start of use of deposited funds.* Use of the deposited funds for rehabilitation financing assistance (e.g., first loan is made, subsidized or guaranteed) must start within 45 days of the deposit. Should use of deposited funds not start within 45 days, the recipient may be required by HUD to return all or part of the deposited funds to the letter of credit.

(f) *Return of unused deposits.* At the termination of the period of the agreement, all unobligated funds (funds of the rehabilitation fund that have not been encumbered or disbursed) then on deposit shall be returned to the recipient's letter of credit unless the block grant recipient has been or is being authorized by HUD to extend the agreement for an additional period. In addition, the block grant recipient shall reserve the right to withdraw from the rehabilitation fund any unobligated amounts required by HUD in the exercise of corrective or remedial actions authorized under § 570.910(b) of the regulations.

(g) *Interest earned on the rehabilitation fund.* Interest earned on the rehabilitation fund shall be used pursuant to the terms and conditions of the agreement consistent with the uses authorized under paragraph (c) of this section.

(h) *Request for HUD review and approval of lump sum drawdown.* HUD area office review and approval of a request for a lump sum drawdown is required prior to drawdown. HUD review can be carried out anytime during the program year but generally HUD will review these requests as a part of the review and approval of a block grant application except those requests submitted in conjunction with grants made under the Secretary's fund for new communities. A request submitted in connection with the new communities fund is subject to the requirements of this section; however it shall be reviewed and approved by the New Communities Development Corporation, which approves and administers grants under the new communities fund. All requests for drawdown shall include:

(1) A copy of the written agreement described in paragraph (b);

(2) The reasons for the locality's belief that the agreement meets the HUD approval standards set forth in paragraph (i); and

(3) Certification, described in paragraph (i)(2)(i); where the request proposes that the benefit to be derived from lump sum drawdown qualifies under paragraph (i)(2)(i).

(i) *HUD review criteria for approval of lump sum drawdown request.* The HUD area office shall approve a request for lump sum drawdown if it determines that the funds will be deposited in one or more private financial institutions under an agreement which includes, one or more of the commitments described in paragraph (i)(1) of this section; meets the benefit tests described in paragraph (i)(2) of this section; meets the tests concerning the amount of drawdown described in paragraph (i)(3) of this section; and otherwise meets the requirements of paragraph (b) of this section. Consistent with the national goal of expanding the opportunities for minority business enterprises, the HUD area office shall encourage block grant recipients to use minority banks (a bank which is owned at least 50 percent by minority group members).

(1) *Commitments by private financial institutions.* (i) Commitment of private funds for the rehabilitation financing activities in amounts which are substantially in excess of the deposit of block grant funds;

(ii) Commitment of private funds for rehabilitation financing activities at below-market interest rates, or with longer repayment periods, or at higher risk than would normally be taken;

(iii) Provision of administrative services by the financial institutions in support of the rehabilitation financing activities at no cost or at reduced cost.

(2) *Benefit tests.* (i) *When market rate interest is payable on the rehabilitation fund*—When interest at the market rate for deposits of similar maturity and size is payable on the rehabilitation fund, the applicant must certify that the commitment under the agreement pursuant to paragraph (i)(1) provides a

significant benefit meeting the needs of its rehabilitation objectives consistent with its block grant application. Such certification shall be accepted by the Area Office for the purpose of meeting the requirements of the benefits test of this paragraph in the absence of substantial evidence to the contrary.

(ii) *When market rate interest is not payable on the rehabilitation fund*—When less than the market rate interest is payable on the rehabilitation fund, the value of the benefits of the commitment under the agreement must be at least equal to the interest foregone. The comparison of the benefit and interest foregone shall be based on the following:

(A) *Estimate of foregone interest*—An estimate of the difference between the interest payable under the agreement and the amount of interest that would be earned on the estimated average monthly balance of the rehabilitation fund at the market rate for deposits of similar maturity and size.

(B) *Estimate of value of benefits*—A quantified estimate of the value of the benefits of the commitment under the agreement. For example, if as a result of the deposit the private financial institution provides free loan origination services, the benefit would be quantified as the amount of the direct fee that would otherwise have to be paid for such services.

(3) *Basis for amount of drawdown.* The amount of funds that a block grant recipient proposes to draw for deposit for a rehabilitation fund shall not exceed the amount of funds that the applicant reasonably expects will be required under the terms of the agreement during the period of the agreement and based on either:

(i) Prior level of rehabilitation activity; or

(ii) Rehabilitation staffing and management plans of the locality for the period of the agreement.

* * * * *

(Title I, Housing and Community Development Act of 1974 (42 U.S.C. 5301 et seq.); Title I, Housing and Community Development Act of 1977 (Pub. L. 95-128); and section 7(d), Department of Housing and Urban Development Act (42 U.S.C. 3535(d).)

Issued at Washington, D.C., March 21, 1979.

ROBERT C. EMBRY, Jr.,

Assistant Secretary for Community Planning and Development.

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